



0000085408

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MIKE GLEASON, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

Arizona Corporation Commission

DOCKETED

MAY 27 2008

DOCKETED BY

nr

IN THE MATTER OF THE APPLICATION OF
UNS ELECTRIC, INC. FOR THE
ESTABLISHMENT OF JUST AND REASONABLE
RATES AND CHARGES DESIGNED TO
REALIZE A REASONABLE RATE OF RETURN
ON THE FAIR VALUE OF THE PROPERTIES OF
UNS ELECTRIC, INC. DEVOTED TO ITS
OPERATIONS THROUGHOUT THE STATE OF
ARIZONA AND REQUEST FOR APPROVAL OF
RELATED FINANCING.

DOCKET NO. E-04204A-06-0783

DECISION NO. 70360OPINION AND ORDER

DATES OF HEARING: September 10, 11, 12, 13, 14, 20, 21, and October 2, 2007.

PLACE OF HEARING: Phoenix, Arizona

ADMINISTRATIVE LAW JUDGE: Teena Wolfe¹

IN ATTENDANCE: William A Mundell, Commissioner
Kristin A. Mayes, Commissioner

APPEARANCES: Mr. Michael W. Patten and Mr. Jason Gellman,
ROSHKA, DEWULF & PATTEN, PLC, on behalf of
UNS Electric, Inc.;

Ms. Michelle Livengood on behalf of Unisource Energy
Services;

Mr. Daniel Pozefsky, on behalf of the Residential Utility
Consumer Office;

Mr. Marshall Magruder, in propria persona; and

Ms. Maureen Scott, Senior Attorney, and Mr. Kevin
Torrey, Staff Attorney, Legal Division, on behalf of the
Utilities Division of the Arizona Corporation
Commission.

¹ Administrative Law Judge Teena Wolfe conducted the hearing in this case and Administrative Law Judge Dwight Nodes drafted the Recommended Opinion and Order.

TABLE OF CONTENTS

1	INTRODUCTION	2
2	Rate Application.....	4
3	RATE BASE	5
4	Construction Work in Progress	5
5	Post-Test-Year Plant	9
6	Deduction of Customer Advances	10
7	AFUDC Accrual on New Construction Projects	11
8	Accumulated Deferred Income Tax	11
9	Accumulated Depreciation.....	12
10	Working Capital	13
11	Uncontested Rate Base Adjustments	14
12	Reconstruction Cost New Less Depreciation (RCND).....	14
13	Fair Value Rate Base.....	15
14	Summary of Rate Base Adjustments.....	15
15	OPERATING INCOME	16
16	Revenues	16
17	Customer Annualization and Weather Normalization	16
18	CARES Discount	16
19	Service Fee Revenues	17
20	Expenses.....	17
21	Payroll Expense.....	17
22	Pension and Benefits Expense	18
23	Worker's Compensation (Injuries and Damages)	19
24	Incentive Compensation.....	19
25	Performance Enhancement Plan and Officer's	
26	Long-Term Incentive Program.....	20
27	Supplemental Executive Retirement Plan and Stock Base Compensation	21
28	Rate Case Expense	23
29	Bad Debt Expense	24
30	Fleet Fuel Expense	24
31	Postage Expense.....	25
32	Industry Association Dues	26
33	A&G Capitalization	27
34	Corporate Cost Allocations	27
35	Depreciation and Property Taxes for CWIP in Plant in Service.....	28
36	Customer Call Center Expense	28
37	Overhead Line Maintenance	29
38	Southwest Energy Services Markup	29
39	Miscellaneous "Unnecessary" Expenses.....	31
40	Valencia Turbine Fuel.....	33
41	M.A.R.C. Training	33
42	Outside Services for Demand Side Management ("DSM") Program.....	34
43	Depreciation and Amortization Expense	34
44	Property Tax Expense	35
45	Income Tax Expense	36
46	Interest Synchronization.....	37
47	New Depreciation Rates.....	37
48	Net Operating Income	37
49	COST OF CAPITAL	37
50	Capital Structure and Cost of Debt	37
51	Cost of Common Equity	38
52	UNSE	38
53	RUCO.....	41
54	Staff.....	42

1	Conclusion on Cost of Equity	43
2	Chaparral City Decision and Fair Value Rate Base	44
3	AUTHORIZED INCREASE	49
4	RATE DESIGN	49
5	Minimum Customer Charge	49
6	Mandatory Time-of-Use Rates	50
7	Inverted (Inclining) Block Rate Structure	52
8	Consolidation of Rates for Mohave and Santa Cruz	52
9	Demand Charge Differential	53
10	CARES Discount	54
11	Low-Income Customer Issues	55
12	Demand-Side Management Adjustor Mechanism	57
13	EPS/REST Adjustor Mechanism	57
14	Outages for Customers on Life Support Equipment	58
15	Nogales/Citizens 1999 Settlement Agreement	59
16	Magruder Proposed Rate Base Adjustment	60
17	Student Loans and Scholarships	61
18	Proposed Changes to Rules and Regulations	62
19	Line Extension Policies and Service Connection Contribution	62
20	Bill Payment Due Date	63
21	Bill Estimation	65
22	Magruder Suggestions Regarding UNSE Tariffs	66
23	OTHER ISSUES	66
24	Purchased Power and Fuel Adjustment Clause ("PPFAC")	66
25	"Other" Allowable Costs in PPFAC	68
26	PPFAC "Cap"	69
27	RUCO's Proposed PPFAC	71
28	Purchased Power Allocation	73
29	Black Mountain Generating Station	73
30	UNSE	74
31	Staff	75
32	RUCO	76
33	Conclusion	76
34	Financing Approval for BMGS	77
35	FINDINGS OF FACT	79
36	CONCLUSIONS OF LAW	83
37	ORDER	84

1 **BY THE COMMISSION:**

2 On December 15, 2006, UNS Electric, Inc. ("UNSE" or "Company") filed with the Arizona
3 Corporation Commission ("Commission") an application requesting an increase in rates and approval
4 of financing.

5 On January 11, 2007, UNSE filed a Supplement to its Application.

6 On January 12, 2007, the Commission's Utilities Division Staff ("Staff") filed a letter stating
7 that the application, as supplemented by the additional information filed on January 11, 2007, met the
8 sufficiency requirements outlined in A.A.C. R14-2-103, and classifying the company as a Class A
9 utility.

10 On January 24, 2007, Staff filed a Request for Procedural Schedule.

11 On February 1, 2007, a Procedural Order was issued scheduling a hearing for September 10,
12 2007; directing UNSE to publish notice of the application and hearing date; and setting various other
13 procedural deadlines.

14 On March 12, 2007, the Residential Utility Consumer Office ("RUCO") filed an Application
15 to Intervene.

16 On March 15, 2007, Marshall Magruder filed a Motion to Intervene on his own behalf.

17 By Procedural Order issued March 27, 2007, RUCO and Mr. Magruder were granted
18 intervention.

19 On April 5, 2007, the Company filed affidavits of publication and proof of mailing in
20 accordance with the requirements of the February 1, 2007, Procedural Order.

21 On May 31, 2007, Arizona Public Service Company ("APS") filed a Motion to Intervene.

22 On June 12, 2007, Staff filed a Motion for Clarification regarding testimony filing date
23 deadlines.

24 On June 18, 2007, a Procedural Order was issued granting intervention to APS.

25 On June 25, 2007, a Procedural Order was issued clarifying the due dates for testimony, as
26 requested by Staff.

27 With its rate application, UNSE filed its required schedules in support of the application, as
28 well as the direct testimony of D. Bentley Erdwurm, Edmund A. Beck, Michael J. DeConcini, Dallas

1 J. Dukes, Thomas J. Ferry, Kentton C. Grant, Kevin P. Larson, Karen G. Kissinger, and Dr. Ronald
2 E. White.

3 On June 28, 2007, Staff filed the direct testimony of Ralph C. Smith, David C. Parcell,
4 Alexander Igwe, Steve Taylor, Julie McNeely-Kirwan, and Bing Young; RUCO filed the direct
5 testimony of Marylee Diaz Cortez, William A. Rigsby, and Rodney L. Moore; and Mr. Magruder
6 filed his direct testimony.

7 On July 12, 2007, Staff filed the direct testimony of Jerry Anderson and Frank Radigan on
8 rate design issues; and RUCO filed the direct testimony of Ms. Diaz Cortez and Mr. Moore on rate
9 design issues. Mr. Magruder filed his direct rate design testimony on July 13, 2007.

10 On August 14, 2007, UNSE filed the rebuttal testimony of James Pignatelli, Denise Smith,
11 Thomas Hansen, Mr. Ferry, Mr. Grant, Mr. Larson, Ms. Kissinger, Mr. Dukes, Mr. DeConcini, Mr.
12 Beck, and Mr. Erdwurm.

13 On August 24, 2007, Staff filed the surrebuttal testimony of Mr. Smith, Mr. Parcell, Mr.
14 Radigan, Mr. Young, and Ms. McNeely-Kirwan; and RUCO filed the surrebuttal testimony of Ms.
15 Diaz Cortez, Mr. Rigsby, and Mr. Moore. Mr. Magruder filed his surrebuttal testimony on August
16 28, 2007.

17 On August 31, 2007, UNSE filed the rejoinder testimony of Mr. Pignatelli, Ms. Smith, Mr.
18 Hansen, Mr. Ferry, Mr. Grant, Mr. Larson, Ms. Kissinger, Mr. Dukes, Mr. DeConcini, and Mr.
19 Erdwurm.

20 On September 6, 2007, a prehearing conference was conducted to address the order of
21 witnesses and exhibits.

22 The evidentiary hearing commenced as scheduled on September 10, 2007, and additional
23 hearing days were held on September 11, 12, 13, 14, 20, and 21, 2007, and on October 2, 2007. At
24 the close of the hearing, a briefing schedule was established, with initial briefs due on October 30,
25 2007, and reply briefs due on November 13, 2007.

26 On October 11, 2007, October 16, 2007, and October 17, 2007, respectively, UNSE, Staff,
27 and RUCO filed their final schedules in this proceeding.

28 On October 26, 2007, Staff filed an Unopposed Motion for Extension of Time to File Briefs.

1 By Procedural Order issued October 29, 2007, Staff's Motion was granted, and initial briefs
2 and reply briefs were directed to be filed by November 5, 2007, and November 19, 2007,
3 respectively.

4 Initial briefs were filed on November 5, 2007, by UNSE, Staff, and RUCO. Mr. Magruder's
5 initial brief was filed on November 6, 2007.

6 On November 6, 2007, Staff filed a Notice of Errata to correct clerical errors in its initial
7 brief.

8 On November 8, 2007, RUCO filed revised final schedules.

9 On November 14, 2007, RUCO filed its reply brief.

10 On November 16, 2007, Mr. Magruder filed his reply brief.

11 On November 19, 2007, UNSE and Staff filed their reply briefs.

12 On November 21, 2007, UNSE filed an Appendix in support of its reply brief.

13 On December 21, 2007, UNSE filed its initial purchased power and fuel adjustment clause
14 rate filing.

15 On December 27, 2007, Mr. Magruder filed late-filed exhibits in response to the Company's
16 reply brief.

17 On January 9, 2008, UNSE filed a response to Mr. Magruder's late-filed exhibits.

18 On January 15, 2008, Mr. Magruder filed a reply to UNSE's response.

19 RATE APPLICATION

20 According to the Company's application, as modified, in the test year ended June 30, 2006,
21 UNSE had adjusted operating income of \$8,770,016, on an adjusted Original Cost Rate Base
22 ("OCRB") of \$141,036,562², for a 6.22 percent rate of return. UNSE requests a revenue increase of
23 \$8,468,638; Staff recommends a revenue increase of \$3,687,885; and RUCO recommends an
24 increase of \$1,282,144. A summary of the parties' positions follows.

25 ...

26 ...

27 ² UNSE submitted two separate sets of final schedules, one assuming the Black Mountain Generating Station ("BMGS")
28 is excluded from rate base in this case and the other including the BMGS in rate base (see discussion below regarding the
BMGS issue). The table below reflects the final schedules excluding the BMGS.

	<u>Company Proposed</u>	<u>Staff Proposed</u>	<u>RUCO Proposed</u>
1 ORIGINAL COST			
2 Adjusted Rate Base	\$141,036,562	\$130,740,050	\$128,795,088
3 Rate of Return	9.89%	8.99%	8.07%
4 Req'd Operating Inc.	13,950,795	11,749,701	11,171,449
5 Op. Income Available	8,770,016	9,505,982	10,388,213
6 Operating Inc. Def.	5,180,780	2,243,719	783,236
7 Rev.Conver. Factor	1.6346	1.6346	1.6370
8 Gross Rev. Increase	8,468,638	3,667,642	1,282,144
9 FAIR VALUE			
10 Adjusted Rate Base	\$177,847,579	\$167,551,067	\$161,635,350
11 Rate of Return	4.93%	7.02%	6.43%
12 Req'd Operating Inc.	17,592,000	11,762,085	11,171,449
13 Op. Income Available	8,770,016	9,505,982	10,388,213
14 Operating Inc. Def.	8,821,983	2,256,103	783,236
15 Rev.Conver. Factor	1.6346	1.6346	1.6370
16 Gross Rev. Increase	8,468,638	3,687,885 ³	1,282,144

RATE BASE

Based on the final schedules filed in this case, UNSE proposed an OCRB of \$141,036,562; Staff recommends an OCRB of \$130,740,050; and RUCO proposed an OCRB of \$128,795,088. Each of the disputed issues regarding rate base items is discussed below.

Construction Work in Progress

Construction work in progress ("CWIP") is a regulatory concept under which, in limited circumstances, a regulatory body allows recovery in a company's rate base for plant that was under construction during the test year but not used and useful for purposes of serving customers. In this proceeding, UNSE seeks inclusion of approximately \$10.8 million of CWIP (which would provide the Company with approximately \$2.1 million in additional annual revenues). In support of its position, UNSE argues that CWIP is an accepted aspect of ratemaking that has been used in many states and that the Arizona Supreme Court previously upheld the allowance of CWIP, citing *Arizona Community Action Assoc. v. Arizona Corp. Comm'n*, 123 Ariz. 228, 230, 599 P.2d 184, 186 (1979). In that case, the Arizona Supreme Court stated that allowing CWIP "appears to be in the public

³ Staff's gross revenue increase was calculated by applying a zero cost value to the "excess" between OCRB and FVRB.

1 interest to have stability in the rate structure within the bounds of fairness and equity rather than a
2 constant series of rate hearings.” (*Id.*).

3 UNSE contends that it will not be able to earn its authorized rate of return even if its full rate
4 request is granted in this case, due to the high rate of growth in its service area, which requires higher
5 levels of capital investment to serve new customers. The Company claims that approximately \$5.6
6 million of the requested \$10.8 million of proposed CWIP is related to substations, transmission and
7 distribution facilities, improvements, and other infrastructure reinforcements, and that those capital
8 expenditures will not produce new revenue or reduce the Company’s expenses but, instead, will
9 improve service reliability for both new and existing customers (Tr. 1068-69). UNSE witness
10 Kentton Grant also stated that \$8.7 million of the \$10.8 million CWIP total was in service as of June
11 30, 2007, and is currently serving customers (Ex. A-35, at 19, 35; Tr. 995). The Company also
12 claims that it is in the “unique” situation of having to replace its entire power supply portfolio by
13 June 1, 2008 and must refinance \$60 million of long-term debt in August 2008.

14 UNSE contends that its continuing revenue deficiency is due, in large part, to the gap between
15 its embedded plant investment and the incremental plant investment calculated on a per-customer
16 basis. The Company contends that its level of growth, and the corresponding revenue deficiency, is
17 extraordinary and allowance of its CWIP request would improve the Company’s cash flow and
18 bolster its financial integrity. Mr. Grant claims that the Company’s long-term financial integrity
19 would be enhanced by allowing CWIP, because such an allowance would enable UNSE and its
20 customers to avoid higher costs of debt and capital (*Id.* at 10).

21 UNSE cites to decisions in several other states to support its CWIP argument. For example,
22 UNSE points out that the Virginia State Corporation Commission allowed CWIP in rate base in two
23 separate decisions⁴, and the Maryland Public Service Commission likewise recently allowed CWIP in
24 rate base for two of its jurisdictional utilities⁵. UNSE also cites to decisions by regulatory
25 commissions in South Carolina, Washington, Illinois, Michigan, Texas, Florida, and Nevada, to
26

27 ⁴ *Application of Massanutten Public Service Corporation*, 2005 WL 2158929 (Va. S.C.C.), at 2; *Appalachian Power Co.*,
2007 WL 1616129 (Va.S.C.C.), at 4.

28 ⁵ *Potomac Energy Power Co.*, 2007 WL 2159658 (Md. P.S.C.), at 20-22; *Washington Gas Light Power Co.*, 2003 WL
23282178 (Md. P.S.C.), at 1, 15).

1 support its argument that allowance of CWIP in rate base is sometimes found to be necessary to
2 maintain the financial integrity of regulated utility companies⁶.

3 Staff and RUCO oppose inclusion of CWIP in the Company's rate base. Staff witness Ralph
4 Smith stated that, although the Commission has previously allowed CWIP in rate base, the
5 Commission's general practice has been not to allow CWIP. In support of Staff's disallowance
6 recommendation, Mr. Smith claims that absent compelling reasons, which have not been shown by
7 UNSE in this case, there is no valid reason to grant CWIP. Mr. Smith asserts that the Company has
8 not demonstrated that its test year CWIP balance was for non-revenue-producing and non-expense-
9 reducing plant. Mr. Smith stated that, although test year revenues have been annualized to year-end
10 customer levels, revenues have not been extended beyond the test year to correspond to customer
11 growth. Thus, according to Mr. Smith, inclusion of CWIP in rate base, without recognition of the
12 incremental revenue the plant supports, would cause a mismatch for regulatory purposes (Ex. S-56, at
13 13-18; Ex. S-58, at 7-15).

14 RUCO witness Marylee Diaz Cortez also recommends disallowance of CWIP for many of the
15 same reasons cited by Staff witness Ralph Smith. Ms. Diaz Cortez stated that the Commission has
16 previously allowed CWIP only in extraordinary circumstances, which she claims are not present in
17 this case. She claims that recovery of earnings on CWIP plant balances prior to the plant becoming
18 used and useful is accomplished through an Allowance for Funds Used During Construction
19 ("AFUDC"), through which the Company may accrue interest on the CWIP balances. The AFUDC
20 accruals are ultimately recovered over the life of the plant through depreciation expense once the
21 asset becomes used and useful in provision of utility service (RUCO Ex. 8, at 15-18; RUCO Ex. 10,
22 at 8-10). Ms. Diaz Cortez testified that regulatory lag has always been a characteristic of rate of
23 return regulation and that such lag may also provide a benefit to the Company, to the extent that plant
24 retirements, accumulated depreciation, and expired amortizations allow it to earn a return on those
25 items between rate cases. She also stated that the growth phenomenon in the UNSE service area has

26 ⁶ *South Carolina Electric & Gas Co.*, 2003 WL 1818431 (S.C. P.S.C.), at 36-7; *Puget Sound Energy, Inc.*, 2007 WL
27 184670 (Wash. U.T.C.), at 39; *Commonwealth Edison Co.*, 2006 WL 2101442 (Ill. C.C.), at 43; *Consumers Energy Co.*,
28 2006 WL 3421084 (Mich. P.S.C.), at 1; *Texas Utilities Electric Co.*, 1991 WL 354928 (Tex. P.U.C.), at 175-6, 456;
Tampa Electric Co., 49 P.U.R.4th 547 (1982); *Nevada Power Co.*, 132 P.U.R.4th 416 (1991); *Nevada Power Co.*, 2007
WL 2171450 (Nev. P.U.C.), ¶303.

1 a positive aspect due to the increase of revenues associated with serving new customers (RUCO Ex.
2 8, at 11-14).

3 We agree with Staff and RUCO that the request for CWIP in this case is not supported by the
4 record. In the recent UNS Gas rate case (Decision No.70011, at 5-7), we rejected nearly identical
5 arguments made by the Company, and we see no relevant distinction that would cause us to depart
6 from that Decision. As the Staff and RUCO witnesses indicated in this proceeding, UNSE is not
7 faced with an extraordinary situation that would justify inclusion of CWIP in rate base because the
8 plant required to serve new customers will help produce revenues; UNSE has a means, through
9 accrual of AFUDC, to mitigate the effect of the CWIP investment; allowance of CWIP would
10 undermine the balancing of test year revenues and expenses; and the regulatory lag inherent in utility
11 regulation may provide benefits to the extent that items such as plant retirements and accumulated
12 depreciation occur between test periods and thereby help to mitigate periods of higher plant
13 investment associated with customer growth.

14 As Staff points out in its brief, one of the few instances in which this Commission previously
15 allowed inclusion of CWIP in rate base occurred in 1984 in a case involving Arizona Public Service
16 Company. In that case, the Commission addressed the need for a CWIP allowance due to
17 extraordinary circumstances involving the Palo Verde nuclear plant. The Commission allowed
18 approximately \$200 million of APS's \$600 million CWIP balance as a means of addressing a critical
19 cash-flow deficiency, and as a means to lessen the severe rate shock that would be experienced by
20 customers if the entirety of the nuclear plant were placed in rate base at one time.⁷ Staff argues that
21 UNSE is not faced with a comparable cash-flow crisis, and that the \$10.8 million of CWIP requested
22 by the Company does not present a rate shock concern that would justify inclusion of CWIP in this
23 case. We therefore decline the Company's request for rate base recognition of CWIP in this
24 proceeding.

25 ...

26 ...

27

28 ⁷ *Arizona Public Service Co.*, Decision No. 54247 (November 28, 1984), at 19-20.

1 Post-Test-Year Plant

2 UNSE proposes that, if its request for CWIP is denied, the Commission should alternatively
3 allow inclusion of post-test-year plant in rate base. The Company argues that the Commission has
4 approved post-test-year plant in a number of recent cases, and UNSE faces faster growth than many
5 other utilities in Arizona. UNSE argues that, absent inclusion of CWIP, the Commission should
6 recognize inclusion of post-test-year plant.

7 Staff opposes the Company's proposal for reasons similar to the arguments raised on the
8 CWIP issue. Staff witness Ralph Smith testified that the post-test-year plant arguments suffer from
9 the same flaws as the request for inclusion of CWIP. He stated his belief that recognition of post-
10 test-year plant would be imbalanced because it fails to capture post-test-year revenue growth and
11 decreases in maintenance costs associated with the new plant (Ex. S-56, at 17-18).

12 We agree with Staff that post-test-year plant should not be included in rate base for the same
13 reasons stated above with respect to the Company's request for CWIP. This issue is virtually
14 identical to that raised in the UNS Gas case (Decision No. 70011, at 7-8). As we stated in that
15 Decision, "although the Commission has allowed post-test-year plant in several prior cases involving
16 water companies, it appears that the issue was developed on the record in those proceedings in a
17 manner that afforded assurance that a mismatch of revenues did not occur" (*Id.*) For example, in
18 Decision No. 66849 (March 19, 2004), we stated that "we do not believe that adoption of this method
19 would result in a mismatch because the post-test-year plant additions are revenue neutral (*i.e.*, not
20 funded by CIAC or AIAC)" (*Id.* at 5). In the instant case, however, the Company's request appears
21 to be simply a fallback to its CWIP position, and there is no development of the record to support
22 inclusion of the post-test-year plant. The entirety of UNSE's argument consists of two questions in
23 Mr. Grant's direct testimony, which essentially provided that: the Commission has approved post-
24 test-year plant in some prior cases, UNSE is experiencing a high customer growth rate, and therefore
25 the Company is entitled to inclusion of post-test-year plant if the Commission denies CWIP (Ex. A-
26 34, at 29-30; Ex. A-35, at 35). Even if we were inclined to recognize post-test-year plant in this case,
27 there is not a sufficient basis upon which to evaluate the reasonableness of the request (*i.e.*, whether a
28 mismatch would exist). We therefore deny the Company's proposal on this issue.

1 Deduction of Customer Advances

2 The final issue raised by UNSE related to the allowance of CWIP is the Company's request
3 that the Commission not reduce rate base to recognize funds received for customer advances, if the
4 Commission rejects UNSE's request for CWIP or, alternatively, for post-test-year plant. The
5 Company concedes that such advances are typically deducted from rate base because they represent
6 customer-supplied capital. However, UNSE contends that it has received approximately \$1.9 million
7 in customer advances related to the \$10.8 million in CWIP plant investment (Ex. A-35 at 19).

8 UNSE argues that it is inherently unfair to exclude the advances from rate base if the plant
9 associated with those advances is not yet in service and not included in rate base. UNSE claims that
10 the purpose of deducting advances (*i.e.*, recognizing customer-supplied capital) is not furthered when
11 the plant is not in service. The Company also contends that the deduction of advances in this case
12 would discourage utilities from seeking advances to offset infrastructure capital costs.

13 Staff opposed the Company's recommendation. Staff witness Ralph Smith stated that because
14 advances represent non-investor-supplied capital, they should be reflected as a deduction to rate base.
15 He stated that Staff is not aware of any instance in which CWIP was excluded for a major utility in
16 Arizona and customer advances were not reflected as a deduction to rate base. Mr. Smith also cited
17 to A.A.C. R14-2-103, Appendix B, Schedule B-1, which he claims requires companies to reflect
18 advances as a deduction from rate base. Finally, Mr. Smith testified that the Company's computation
19 of AFUDC does not reduce the project balance, on which the AFUDC rate is applied, for customer
20 advances. Rather, UNSE records customer advances in a liability account (Ex. S-58 at 17; Tr. 1039-
21 41).

22 Consistent with our treatment of this issue in the UNS Gas rate case, we agree with Staff that
23 advances represent customer-supplied funds that are properly deducted from the Company's rate
24 base. Indeed, the Commission's own rules contemplate that such a deduction is required, as Staff
25 witness Smith testified. Had UNSE not requested the inclusion of CWIP in rate base, a ratemaking
26 treatment that is only afforded under extraordinary circumstances (and apparently has not occurred
27 for more than 20 years), there would presumably not have been an issue raised by the Company with
28 respect to an alleged "mismatch" between exclusion of CWIP and deducting advances from rate base.

1 The Company's attempt to frame this issue as one in which it is being treated in a discriminatory
2 manner is unpersuasive.

3 As we have stated in prior cases, regulated utility companies control the timing of their rate
4 case filings and should not be heard to complain when their chosen test periods do not coincide with
5 the completion of plant that may be considered used and useful and therefore properly included in
6 rate base. We believe our conclusions regarding UNSE's CWIP-related proposals are entirely
7 consistent with the treatment that has been afforded to other utility companies regulated by the
8 Commission and provide a result that is fair to both the Company and its customers.

9 AFUDC Accrual on New Construction Projects

10 UNSE witness Grant proposed that, even if the Commission grants its request for inclusion of
11 CWIP in rate base, the Company should be permitted to continue accruing AFUDC on all eligible
12 construction projects on a going-forward basis (Ex. A-35, at 35-6). Given our denial of the
13 Company's CWIP proposal, this issue becomes a moot point.

14 Accumulated Deferred Income Taxes

15 Based on its recommendations in this case, Staff adjusted rate base by \$161,555 to account for
16 removal of accumulated deferred income tax ("ADIT") related to its recommendation regarding the
17 Company's Supplemental Executive Retirement Plan ("SERP"), and removal of the ADIT related to
18 stock-based compensation (Ex. S-58 at 19-20). Staff claims that UNSE did not contest these ADIT
19 adjustments, which Staff asserts are necessary to reconcile rate base with the components of
20 operating income adjustments.

21 In its brief, UNSE does not dispute the ADIT issues raised by Staff, which are reconciliation
22 adjustments flowing through from several operating income issues and are addressed below.
23 However, the Company does take issue with RUCO's proposed adjustments related to ADIT for
24 Contributions in Aid of Construction ("CIAC") and for Administrative and General ("A&G")
25 expenses (Ex. A-7 at 11-12).

26 RUCO witness Marylee Diaz Cortez recommended removal of \$888,390 from UNSE's rate
27 base based on her claim that the Company failed to follow the NARUC Uniform System of Accounts
28 ("USOA") requirement to include CIAC in Account 271 (RUCO Ex. 10-11). With respect to ADIT

1 for the Company's A&G expenses, Ms. Diaz Cortez recommends removal of \$116,258 from rate
2 base to reflect RUCO's proposed operating income adjustment for A&G expenses (RUCO Ex. 8, at
3 20).

4 UNSE witness Karen Kissinger testified that the Commission's rules (A.A.C. R14-02-
5 212.G.2) require electric utilities to use FERC's USOA, which differs from the NARUC USOA
6 because the FERC USOA does not include an Account 271. Instead, according to Ms. Kissinger,
7 UNSE is required to directly credit the related plant or CWIP, and there is no separate account to
8 deduct from rate base as RUCO proposes (Ex. A-13, at 2). She stated that, pursuant to Decision No.
9 55774 (October 21, 1987), the Company is permitted to create a tax deferred asset and claim rate base
10 treatment when using the self-pay method (Ex. A-12, at 6-9).

11 With respect to RUCO's proposal for a rate base reduction for ADIT related to A&G
12 expenses, Ms. Kissinger pointed out that the Company's proposal to reduce the test year level of
13 A&G expense charged to CWIP, and correspondingly increase the amount remaining in operating
14 expenses, is prospective only and therefore no further adjustment is necessary (Ex. A-12, at 9).

15 Based on the record before us, we agree that the appropriate reconciliation adjustments should
16 be made to reflect the effect on ADIT in accordance with this Decision. However, we disagree with
17 RUCO's recommendations to reduce rate base. Company witness Kissinger explained that UNSE is
18 required by the Commission's rules to follow the FERC USOA, and that UNSE accounted for ADIT
19 related to CIAC in accordance with those accounting standards. She also testified that, because the
20 Company's A&G expense proposal is prospective only, there is no need to adjust ADIT even if the
21 Commission rejects the Company's proposed expense treatment for A&G expenses. RUCO's ADIT
22 recommendations are denied.

23 Accumulated Depreciation

24 UNSE proposed \$159,524,693 for its test year accumulated depreciation. RUCO
25 recommended an increase in the Company's accumulated depreciation of \$2,295,112, for a total of
26 \$161,819,805. RUCO witness Rodney Moore claims that UNSE was unable to substantiate its
27 December 31, 2003, accumulated depreciation balance, which he asserts is understated by
28 \$1,764,719, due to the fact that the Company did not record any plant additions or retirements

1 between August 11, 2003 (the date of UNSE's acquisition of the assets of Citizens Utilities Company
2 ("Citizens")) and the end of 2003. He contends that accumulated depreciation during this period, as
3 well as an additional amount of depreciation of \$503,393 to the end of the test year, is not recognized
4 by the Company's application (RUCO Ex. 7, at 4-6).

5 In response, UNSE argues that RUCO used incorrect depreciation rates for two classes of
6 transportation equipment (25 percent instead of 12.5 percent), a point Mr. Moore conceded on cross-
7 examination (Tr. 860-61; 867-68). According to UNSE, this error alone has an impact of more than
8 \$1.8 million (Ex. A-38). Ms. Kissinger also testified that RUCO failed to make other calculations in
9 accordance with the FERC USOA (Ex. A-13, at 1), and cites as an example RUCO's use of a mid-
10 year depreciation convention rather than the mid-month convention used by the Company (Ex. A-12,
11 at 10). She further claims that RUCO failed to consider salvage and removal costs associated with
12 retired assets, and improperly depreciated transportation equipment based on the group method rather
13 than the unit method (Ex. A-12, at 10).

14 We agree with UNSE that it has adequately supported its proposed accumulated depreciation
15 in this case. As Ms. Kissinger points out, RUCO's analysis contains several errors that have a
16 substantial impact on the recommendations it puts forth. The Company's witness testified that
17 RUCO's use of an incorrect depreciation rate for certain equipment could increase depreciation by
18 more than \$1.8 million, and that other errors in RUCO's calculations inflated its depreciation
19 recommendation in this proceeding. We therefore reject RUCO's proposal on this issue.

20 Working Capital

21 As described by UNSE witness Karen Kissinger, working capital is generally defined as
22 "investor funding in excess of the balance of net utility plant reflected in rate base that is required for
23 the provision of utility service" (Ex. A-11 at 10). The components of working capital include
24 materials and supplies, prepayments, and cash working capital. The amounts for materials and
25 supplies, and prepayments, are determined based on test year recorded balances, whereas the cash
26 working capital component was determined by UNSE based on a lead-lag study (*Id.*).

27 Staff witness Ralph Smith summarized the concept of cash working capital as follows:
28

1 Cash working capital is the cash needed by the Company to cover its day-
2 to-day operations. If the Company's cash expenditures, on an aggregate
3 basis, precede the cash recovery of expenses, investors must provide cash
4 working capital. In that situation, a positive cash working capital
5 requirement exists. On the other hand, if revenues are typically received
6 prior to when expenditures are made, on average, then ratepayers provide
the cash working capital to the utility, and the negative cash working
capital allowance is reflected as a reduction to rate base. In this case, the
cash working capital requirement is a reduction to rate base as ratepayers
are essentially supplying these funds (Ex. S-56 at 21).

7 Based on Staff's proposed adjustments, Mr. Smith proposed a corresponding adjustment to
8 the Company's cash working capital requirements. Staff's recommendation results in a cash working
9 capital requirement of negative \$2.405 million, in accordance with Staff's other recommendations in
10 this case (See Staff Final Schedules, Sched. B-4).

11 UNSE agrees that there should be a negative cash working capital allowance, but the amount
12 of the Company's recommendation differs from that of Staff based on the rate base and operating
13 expense adjustments advocated by the respective parties.

14 It does not appear from the record that the parties are in disagreement with regard to the
15 underlying working capital requirements, subject to the various adjustments that necessarily flow
16 from the revenue requirement established in this Decision.

17 Uncontested Rate Base Adjustments

18 According to UNSE, two rate base adjustments are unopposed: \$9,574,286 for an acquisition
19 adjustment, and a \$440,000 reduction to rate base for plant held for future use (UNSE Initial Brief, at
20 20). None of the other parties disputed the Company's claim, and we will therefore adopt these
21 unopposed adjustments.

22 Reconstruction Cost New Less Depreciation ("RCND")

23 To determine its RCND in this proceeding, UNSE used its final OCRB recommendation as a
24 starting point, and added increased costs through indices of inflation, such as the Handy-Whitman
25 Index (Ex. A-11, at 16-18). Although Staff accepted the Company's RCND methodology, Staff
26 contends that UNSE should not be granted a revenue requirement on FVRB that was substantially
27 higher, because the acquisition of Citizens at a substantial discount to book value cast doubt on
28

1 whether a traditional RCND measurement is a good indicator of the fair value under the facts of this
2 case.

3 Fair Value Rate Base

4 UNSE, Staff and RUCO all determined FVRB based on an average of OCRB and RCND.
5 The principal reason for the difference Staff and the Company FVRB recommendations is related to
6 CWIP, which is discussed above.

7 Summary of Rate Base Adjustments

8 Based on the foregoing discussion, we adopt an adjusted OCRB of \$130,740,050 and a Fair
9 Value Rate Base ("FVRB") of \$167,551,067.

10 ORIGINAL COST:

11	Plant in Service	\$380,194,752
12	Less: Accumulated Depreciation	<u>(159,524,693)</u>
	Net Plant in Service	220,670,059
13	Citizens Acquisition Discount	(93,273,341)
14	Less: Accum. Amort. – Citizens Acq. Disc.	<u>(11,224,066)</u>
	Net Citizens Acq. Discount	<u>(82,049,275)</u>
15	Total Net Utility Plant	138,620,784
16	<u>Deductions:</u>	
	CIAC	(8,692,444)
17	Customer Deposits	(3,778,419)
	Accum. Deferred Income Taxes	<u>993,278</u>
18	Total Net Deductions and Additions	(11,477,585)
	Allowance for Working Capital	<u>3,596,851</u>
19	Total OCRB	\$130,740,050

20 RCND RATE BASE:

21	Plant in Service	\$602,007,163
22	Less: Accumulated Depreciation	<u>(257,585,628)</u>
	Net Plant in Service	344,421,535
23	Citizens Acquisition Discount	(150,061,415)
24	Less: Accum. Amort. – Citizens Acq. Disc.	<u>(18,123,969)</u>
	Net Citizens Acq. Discount	<u>(131,937,446)</u>
25	Total Net Utility Plant	212,484,089
26	<u>Deductions:</u>	
	CIAC	(9,559,141)
27	Customer Deposits	(3,778,419)
28	Accum. Deferred Income Taxes	<u>1,618,703</u>

1	Total Deductions	(11,718,857)
	Allowance for Working Capital	<u>3,596,851</u>
2	Total RCND	\$204,362,083
3	FAIR VALUE RATE BASE:	
	Original Cost	\$130,740,050
4	RCND	<u>204,362,083</u>
5	Total	335,102,133
	Average (FVRB)	\$167,551,067

OPERATING INCOME

According to the Company's Final Schedules, in the test year, the Company's reported adjusted operating revenues were \$158,483,263, with reported adjusted test year operating expenses of \$149,713,247, and test year net operating income of \$8,770,016. As set forth in its Surrebuttal Schedules (Ex. S-60), Staff's proposed adjusted test year operating revenues were \$158,539,827, with adjusted test year operating expenses of \$149,033,845, resulting in test year net operating income of \$9,505,982. RUCO's Final Schedules show proposed adjusted test year operating revenues of \$158,531,911, with adjusted test year operating expenses of \$148,143,698, yielding test year net operating income of \$10,388,213. The disputed expense adjustments are discussed below.

Revenues

Customer Annualization and Weather Normalization

UNSE states that all parties have agreed with the Company's proposed customer annualization and weather normalization adjustments of \$3,249,883 and (\$410,061), respectively. Given that no dispute remains regarding these issues, the proposed adjustments shall be adopted.

CARES Discount

UNSE proposed a reduction to its test year revenues related to a change proposed by the Company for treatment of discounts received by customers on the CARES program (Ex. A-17, at 24). Staff witness Julie McNeely-Kirwan opposed the changes proposed by the Company (Ex. S-67, at 2-3), and Staff therefore recommended that the Company's test year revenues be increased by \$52,937 (Ex. S-56, at 23).

The CARES issue is addressed below in the Rate Design section of this Order. Given our agreement with Staff on this issue, Staff's recommended adjustment to revenues will be adopted.

1 Service Fee Revenues

2 As discussed below in the Rate Design section of this Order, RUCO witness Marylee Diaz
3 Cortez recommended that \$48,648 should be added to the Company's revenues to reflect RUCO's
4 claim that the proposed service fees for after-hours establishment and reconnection of service do not
5 fully reflect the Company's actual costs (RUCO Ex. 8, at 21). UNSE witness D. Bentley Erdwurm
6 stated that the Company shares RUCO's concerns regarding potential cross-subsidies, but the
7 Company recommends that service fees be increased more gradually, consistent with the concept of
8 gradualism (Ex. A-17, at 17).

9 We agree with UNSE's more gradual approach to increasing the service fees in question and
10 therefore do not agree with RUCO's recommendation to adjust revenues.

11 Expenses

12 Payroll Expense

13 UNSE proposes an upward adjustment in its expenses of \$339,184 to reflect known and
14 measurable wage and salary increases that went into effect in 2007. Due to an oversight, the payroll
15 expense increase proposal was not presented until the Company filed its rebuttal testimony. This
16 amount includes normalized overtime expenses of \$139,201, based on a two-year average including
17 the test year and the year prior to the test year (Ex. A-25, at 11-12). UNSE contends that its
18 adjustment only accounts for employee levels at the end of the test year and therefore does not create
19 a mismatch. Company witness Dallas Dukes also claims that the Company's overtime normalization
20 is consistent with the approach advocated by Staff in the recent UNS Gas case, which method was
21 accepted by UNS Gas in that case (Ex. A-24, at 20).

22 Staff witness Ralph Smith testified that Staff opposes the increase recommended by UNSE.
23 Staff claims that, with respect to the overtime adjustment, Mr. Smith's analysis is consistent with the
24 position taken in the UNS Gas case, in which he used the lower of two calculations to reduce
25 overtime costs for UNS Gas. In this case, Staff claims that Mr. Smith conducted the same
26 calculations, one of which resulted in a reduction to overtime and the other showing an increase. Mr.
27 Smith stated that "my analysis of overtime expense, which is presented in Attachment RCS-9, and
28 which followed the same analysis format that I used in the UNS Gas case, indicates that the overtime

1 expenses in UNS Electric's original filing is within a range of reasonableness (i.e., it was bracketed
2 by the results of the two alternative calculations I performed). Consequently, no additional
3 adjustment to overtime for UNS Electric is necessary." (Ex. S-58, at 45-6).

4 Staff also takes issue with the Company's overall proposed payroll adjustment. Staff argues
5 that the proposed adjustment was not presented until UNSE's rebuttal testimony was filed on August
6 14, 2007, leaving very little time for Staff to conduct discovery and develop surrebuttal testimony,
7 which was filed on August 24, 2007. Staff asserts that, in addition to the lateness of the adjustment,
8 the Company's proposal is also inconsistent with treatment of payroll in the UNS Gas case, in which
9 payroll was annualized to the end of the year but not beyond.

10 Although we understand Staff's concern that the Company's proposed adjustment was not
11 presented until its rebuttal testimony was filed, we believe UNSE's proposal should be adopted
12 because it reflects known and measurable payroll changes that went into effect more than a year ago.
13 Mr. Dukes explained that the failure to include the payroll changes in the initial application was due
14 to an oversight, and that the changes have been normalized to minimize a mismatch between the test
15 year and the later payroll increases. We will therefore adopt the Company's recommendation on this
16 issue.

17 Pension and Benefits Expense

18 UNSE proposed an upward adjustment to test year levels of pension and benefits expense of
19 \$82,965. RUCO witness Rodney Moore recommends removing a portion of these expenses,
20 \$11,612, because in a data response UNSE described that portion of the expenses as related to "gifts,
21 awards, employee dinners, picnics and social events" (RUCO Ex. 5, at 12). Mr. Moore stated that
22 RUCO considers these benefits to be an inappropriate burden on ratepayers (*Id.*).

23 UNSE witness Dukes responded that the expenses identified by RUCO are properly included
24 in rates because they are "primarily related to the recognition of employee service, safety
25 accomplishments and other goal achievements by individual or groups of employees" (Ex. A-25, at
26 18). He indicated that rewarding employees enables the Company to retain qualified employees and
27 therefore provides a benefit to customers (*Id.*).

1 We agree that, as a general principle, rewarding employees for performance and longevity
2 provides at least an indirect benefit to customers because service is likely to be enhanced by
3 recognizing employees. However, the Company and its shareholders also benefit from improved
4 employee performance, at least as much as ratepayers, a fact that UNSE fails to acknowledge. If the
5 Company wishes to provide gifts, awards, and other social events as a reward to employees, it should
6 bear at least a portion of the burden associated with these discretionary expenditures. We will
7 therefore reduce expenses by half of the amount identified by RUCO (\$5,806).

8 Worker's Compensation (Injuries and Damages)

9 UNSE argues in its brief that, although it proposed a reduction of \$98,161 to test year
10 expenses booked in FERC Account 925, Staff and RUCO improperly advocated greater reductions.
11 Mr. Dukes conceded that the test year level of \$173,456 for worker's compensation appeared to be
12 "abnormally high" and the Company therefore agreed to reduce that expense by \$98,161 to reflect a
13 three-year average of such costs (Ex. A-24, at 4-5). However, Mr. Dukes disagreed with Staff's and
14 RUCO's proposals to reduce all of the expenses in FERC Account 925, because, according to Mr.
15 Dukes, such reductions would not recognize costs associated with general liability insurance and
16 Officers and Directors liability insurance (Ex. A-25, at 2).

17 Staff points out in its reply brief that its witness, Ralph Smith, agreed at the hearing to modify
18 Staff's position in accordance with the Company's recommendation, and that Staff's revised position
19 is included in its Final Schedules (Staff Initial Brief, at 15). Therefore, despite UNSE's protestations
20 to the contrary, Staff has been in agreement with the Company's position on this issue since the date
21 of Mr. Smith's testimony at the hearing⁸. RUCO did not address this issue in its briefs, and
22 presumably has conceded its position on this issue.

23 Incentive Compensation

24 UNSE proposes to increase test year expenses by \$39,026 to reflect a two-year average of
25 expenses for incentive compensation programs maintained by the Company. UNSE recommends
26

27 ⁸ In this case, as well as the recent UNS Gas case the Company's brief failed to recognize changes in the positions taken
28 by other parties (or its own witnesses), either through surrebuttal testimony, or at the hearing, and which changed
positions were incorporated into the final schedules of that party (*See, e.g.*, Decision No. 70011, at 4, 29-31, 41).

1 recovery of \$168,060 for its Performance Enhancement Plan and \$48,970 for its Officer's Long-Term
2 Incentive Program (Ex. A-23, at 9).

3 Performance Enhancement Plan and Officers' Long-Term Incentive Program

4 UNSE allows its non-union employees to participate in its parent company's Performance
5 Enhancement Plan ("PEP"), which provides eligible employees compensation above their base pay
6 for meeting financial targets (30 percent), cost containment goals (30 percent), and customer service
7 goals (40 percent) (Ex. A-24 at 6-7). Company witness Dukes claims that the PEP is an integral part
8 of its compensation package for employees and that UNSE would be required to increase base
9 salaries to attract and retain qualified employees if the program were eliminated (*Id.*).

10 Staff proposes to adjust the PEP expenses by 50 percent, based on Staff's claim that incentive
11 compensation programs benefit both ratepayers and shareholders. Staff cites to the Southwest Gas
12 Decision to support its position. In that case, the Commission adopted Staff's recommendation to
13 disallow 50 percent of a similar program's costs, based on a finding that the Southwest Gas
14 management incentive program benefited both customers and shareholders. Staff witness Ralph
15 Smith stated that there is no relevant distinction between the UNSE and Southwest Gas incentive
16 programs and that the 50/50 sharing of costs is equally appropriate in this case (Ex. S-58 at 25-27).

17 RUCO proposes a complete disallowance of the PEP costs, based on its claim that it is not
18 clear that the program is necessary to achieve the PEP's goals. RUCO witness Moore testified that,
19 during 2005, no PEP payments were made because UniSource did not meet the program's financial
20 goals. However, the UniSource Board of Directors authorized payment of a Special Recognition
21 Award ("SRA") in 2005 to the employees eligible for the PEP. As a result, UNSE is seeking in this
22 proceeding to recover the average of the 2004 PEP payments and the 2005 SRA costs. Mr. Moore
23 contends that the SRA is unique and does not meet the criteria of a typical and recurring test year
24 expense for which rate recovery should be granted (RUCO Ex. 5 at 14-16). He also stated that 60
25 percent of the PEP payments are related to financial performance and cost containment, which are
26 goals that primarily benefit shareholders. Finally, Mr. Moore asserts that because the PEP does not
27 apply to 70 percent of its employees (*i.e.*, union employees), it is not clear that the program is
28 necessary or will achieve the stated goals (*Id.*; RUCO Ex. 7, at 8-9).

1 Consistent with our finding in the UNS Gas rate case (Decision No. 70011, at 26-27), we
2 believe that Staff's recommendation provides a reasonable balancing of the interests between
3 ratepayers and shareholders by requiring each group to bear half the cost of the incentive program.
4 As RUCO points out, the program is comprised of elements that relate to the parent company's
5 financial performance and cost containment goals, matters that primarily benefit shareholders.
6 However, 40 percent of the program's incentive compensation is based on meeting customer service
7 goals. This offers the opportunity for the Company's customers to benefit from improved
8 performance in that area. For the same reasons, we also adopt Staff's recommendation to disallow 50
9 percent of the Officer's Long-Term Incentive Program (Ex. S-58, at 32). Given that the arguments
10 raised in the UNS Gas case are virtually identical to those presented in this case, we see no reason to
11 deviate from that recent Decision.

12 We also stated in Decision No. 70011 that although we believe, on balance, that the 50/50
13 sharing is reasonable, we share RUCO's concerns that the SRA offered to employees in 2005 may
14 have the effect of undermining the very goals the PEP is intended to achieve (*i.e.*, providing an
15 incentive for participating employees to improve performance and thereby benefit both the Company
16 and its customers). As described by Mr. Moore, despite failing to meet the PEP goals, the UniSource
17 Board of Directors decided nonetheless to provide the affected employees with a surrogate means of
18 compensation. As we indicated in Decision No. 70011, it appears that the SRA sends a signal to
19 employees that they will be compensated regardless of performance, which places the entire premise
20 of the PEP at issue. We expect the program to be scrutinized in the Company's next rate case to
21 determine the appropriateness of providing incentive compensation above base salaries to employees.

22 Supplemental Executive Retirement Plan and Stock Based Compensation

23 UNSE allows select executives to participate in a Supplemental Executive Retirement Plan
24 ("SERP"). The SERP provides to eligible executives retirement benefits in excess of the limits
25 allowed under Internal Revenue Service ("IRS") regulations for salaries in excess of specified
26 amounts. UNSE contends that the \$83,506 of test year SERP costs are reasonable and that neither
27 Staff nor RUCO have shown that the Company's overall executive compensation costs are excessive
28 or out of line with industry standards.

1 Staff and RUCO recommend disallowance of the SERP costs, in accordance with the
2 Commission's Decision in the Southwest Gas case (Decision No. 68487, at 18-19). In that case, we
3 disallowed Southwest Gas's SERP costs, finding:

4 [T]he provision of additional compensation to Southwest Gas' highest
5 paid employees to remedy a perceived deficiency in retirement benefits
6 relative to the Company's other employees is not a reasonable expense
7 that should be recovered in rates. Without the SERP, the Company's
8 officers still enjoy the same retirement benefits available to any other
9 Southwest Gas employee and the attempt to make these executives
10 "whole" in the sense of allowing a greater percentage of retirement
benefits does not meet the test of reasonableness. If the Company wishes
to provide additional retirement benefits above the level permitted by IRS
regulations applicable to all other employees it may do so at the expense
of its shareholders. (*Id.* at 19).

11 We disagree with the Company's argument that disallowance of the SERP costs effectively
12 allows the IRS to dictate what compensation costs should be recovered. As was clearly stated in the
13 passage cited above, and which passage was quoted in the UNS Gas case (Decision No. 70011, at
14 28), the issue is not whether UNSE may provide compensation to select executives in excess of the
15 retirement limits allowed by the IRS, but whether ratepayers should be saddled with costs of
16 executive benefits that exceed the treatment allowed for all other employees. If the Company chooses
17 to do so, shareholders rather than ratepayers should be responsible for the retirement benefits afforded
18 only to those executives. We see no reason to depart from the rationale on this issue in the most
19 recent UNS Gas rate case,⁹ and we therefore adopt the recommendations of Staff and RUCO and
20 disallow the requested SERP costs.

21 For these same reasons, we agree with Staff that test year expenses should be reduced to
22 remove stock-based compensation to officers and employees. As Staff witness Ralph Smith stated,
23 the expense of providing stock options and other stock-based compensation beyond normal levels of
24 compensation should be borne by shareholders rather than ratepayers (Ex. S-58, at 34). The
25 disallowance of stock-based compensation is consistent with the most recent rate case for Arizona
26 Public Service Company (Decision No. 69663).

27
28 ⁹ See also *Arizona Public Service Co.*, Decision No. 69663, at 27 (June 28, 2007), and *Southwest Gas Co.*, Decision No. 68487, at 18-19 (February 23, 2006), wherein SERP costs were excluded in their entirety.

1 Rate Case Expense

2 UNSE requested inclusion of \$600,000 for rate case expense, amortized over three years.
3 UNSE contends that the proposals offered by Staff and RUCO (\$265,000 and \$251,000,
4 respectively), which are based primarily on comparisons to the recent Southwest Gas rate case
5 (Decision No. 68487), are deficient because they fail to recognize that Southwest Gas used internal
6 personnel and support services, internal costs that are built into Southwest Gas' rate base. In
7 comparison, UNSE does not have in-house legal or rate departments, but instead relies heavily on the
8 rate and legal personnel of Tucson Electric Power Company ("TEP") to prosecute its rate cases. Mr.
9 Dukes testified that an allocation from TEP for such costs ensures that TEP customers do not
10 subsidize UNSE operations (Ex. A-24, at 16-17). The Company also argues that Staff and RUCO
11 ignored the fact that UNSE received 21 sets of data requests.

12 RUCO witness Moore stated that RUCO's recommendation in this case is appropriate based
13 on a comparison to the recent UNS Gas rate case, in which RUCO also advocated reducing rate case
14 expense to \$251,000, allocated over three years (RUCO Ex. 5, at 17). RUCO contends that the
15 UNSE case shares similar characteristics with the UNS Gas case in that both companies extensively
16 used in-house staff, and both companies used many of the same witnesses (*Id.*) RUCO therefore
17 recommends a rate case expense allowance of \$251,000, amortized over three years.

18 As indicated above, Staff recommends a rate case expense allowance of \$265,000, normalized
19 over three years, based on Staff's view that the Southwest Gas case raised many of the same issues
20 addressed in this proceeding. Staff witness Ralph Smith disputed the rationale offered by UNSE for
21 its proposed rate case expense. Mr. Smith stated that although this may be the first rate case for this
22 company under its current ownership, the Company had a number of prior periodic rate cases when it
23 was owned by Citizens Utilities. He contends that the transfer of ownership to UNSE should not be
24 used as a basis for imposing "excessive" rate case costs (Ex. S-58, at 35-37). Mr. Smith also testified
25 that because the UNSE rate case presents many issues that are similar to those considered in the
26 Southwest Gas case, the rate case expense allowed in that case is a useful benchmark for the UNSE
27 case (*Id.*). Mr. Smith added that the issue of the appropriateness of allocating TEP shared services
28 would be better addressed in the pending TEP rate case (Docket No. E-01933A-05-0402, et al.).

1 We agree with Staff and RUCO that the Company's proposed rate case expense of \$600,000
2 is excessive and should be reduced significantly. As both Staff and RUCO suggest, the recent
3 Southwest Gas case presented many of the same issues that were raised in this case, and the
4 Southwest Gas case is an appropriate measure of comparison for UNSE. An even better comparison
5 is the recent UNS Gas rate case, in which we allowed rate case expense of \$300,000 normalized over
6 three years (Decision No. 70011, at 22). We believe that proposed rate case expense of \$600,000 is
7 excessive when compared with similar rate case expense allowances in a long line of cases before the
8 Commission. Although Staff and RUCO present strong arguments in support of their
9 recommendations, given that this is the first UNSE rate case since the acquisition of the Citizens
10 assets, and that UNSE was required to respond to a substantial number of data requests, we will allow
11 rate case expense of \$300,000, normalized over three years.

12 Bad Debt Expense

13 In his rebuttal testimony, Mr. Dukes agreed with RUCO's claim that UNSE had mistakenly
14 calculated its bad debt expense using "gross write-offs" rather than applying the write-off percentage
15 to adjusted test year revenues (Ex. A-24, at 21). However, he disagreed with RUCO's proposal to
16 apply the bad debt percentage to actual test year write-off amounts (RUCO Ex. 10, at 12-13).
17 Instead, Mr. Dukes proposes applying the percentage to a three-year average in order to "smooth out"
18 year-to-year fluctuations (Ex. A-24, at 22). Staff witness Smith accepted the Company's proposal to
19 apply the bad debt percentage to a three-year average of net write-offs (Ex. S-58, at 41).

20 Based on the record, we agree with the Company's proposal to apply the bad debt percentage
21 to a three-year average of net write-offs. As Mr. Dukes explained in his rejoinder testimony, bad
22 debt expense fluctuates widely from year-to-year. He stated that UNSE's bad debt expense was
23 \$426,405 in 2004, \$296,428 in 2005, \$495,131 in 2006, and \$715,267 for the period of June 2006 to
24 June 2007 (Ex. A-25, at 13-14). We believe the Company's three-year average proposal provides an
25 appropriate representative level of bad debt expense.

26 Fleet Fuel Expense

27 In his rejoinder testimony, UNSE witness Dukes proposed that the Company's fleet fuel
28 expense be established based on an average gasoline cost of \$2.82 per gallon applied to 214,716

1 gallons, for a total fleet fuel expense of \$605,498 (Ex. A-25 at 1-2). In its brief, UNSE recognized
2 that RUCO had accepted the Company's proposal (RUCO Ex. 10, at 13), but argues that Staff
3 recommends applying the price per gallon to only 207,311 gallons, thereby understating UNSE's
4 expenses (UNSE Initial Brief, at 32-33).

5 In his direct testimony on the witness stand, Staff witness Smith agreed with Mr. Dukes'
6 proposed fleet fuel expense (Tr. 1193). Staff's revised position is also reflected in its Final
7 Schedules. Although Staff reconciled its recommendation during the hearing, in accordance with the
8 Company's position, UNSE's brief continues to advocate rejection of Staff's position. We assume
9 that the Company failed to notice Mr. Smith's revised testimony agreeing with Mr. Dukes' rejoinder
10 testimony, and we further assume that UNSE is not advocating that we reject a position that is
11 identical to its own recommendation. Since there does not appear to be any remaining dispute
12 between any of the parties on this issue, we will adopt the agreed-upon recommendation of the
13 parties.

14 Postage Expense

15 UNSE witness Dallas Dukes proposed inclusion in operating expenses of \$341,321 for
16 postage costs, based on a 2.5 year average, from January 2004 through June 2006 (Ex. A-25 at 21).
17 Staff witness Ralph Smith acknowledged that postage expense should also include recognition of a
18 postal increase that became effective May 14, 2007 (from \$.39 to \$.41), thereby increasing total
19 postage expense by \$17,503, to \$358,824 (Ex. S-56, at 25). Accordingly, no dispute remains
20 between UNSE and Staff on this issue.

21 RUCO witness Rodney Moore continues to disagree with UNSE's averaging of postage
22 expenses. Although RUCO agrees that the known and measurable postage rate increases should be
23 recognized, Mr. Moore believes that the rate should be applied strictly to test year counts (RUCO Ex.
24 7 at 11). As reflected in its Final Schedules (Sched. RLM-9), RUCO's recommendation would
25 reduce postage expense by \$37,956.

26 We agree with the Company's postage expense recommendation, as accepted by Staff.
27 Although RUCO contends that there is not a significant variation in postage expenses from year-to-
28 year, Mr. Dukes testified that, over the past three years, UNSE's postage expenses were \$415,524,

1 \$257,881, and \$365,567, respectively, even though customer counts and bills mailed by the Company
2 have increased over that same time period (Ex. A-25, at 21). Mr. Dukes attributed the postage
3 expense fluctuations primarily to inclusion of informational and educational materials (Ex. A-24, at
4 24, at 29-30). We believe the approach recommended by the Company is adequately supported by
5 the record and should be adopted.

6 Industry Association Dues

7 In his rebuttal testimony, UNSE witness Dukes agreed to remove \$13,759 from test year
8 expenses associated with the Edison Electric Institute's ("EEI") Utility Air Regulatory Group
9 ("UARG") dues (Ex. A-24, at 17-18). In his surrebuttal testimony, RUCO witness Rodney Moore
10 stated that the RUCO was satisfied with the Company's removal of the UARG portion of the dues
11 (RUCO Ex. 7, at 18). However, the Company disagrees with Staff witness Ralph Smith that 49.93
12 percent of UNSE's core EEI dues should also be disallowed on top of the UARG disallowance. Mr.
13 Dukes claims that the dues support EEI in its efforts to advocate on behalf of electric utilities, which
14 ultimately provide a benefit to the Company's customers through such advocacy (Ex. A-24, at 18).

15 Mr. Smith testified that EEI core dues related to legislative advocacy, regulatory advocacy,
16 advertising, marketing, and public relations total 49.93 percent of the total dues, and should therefore
17 be excluded. Mr. Smith cites a decision by the Arkansas Public Service Commission¹⁰ in which a
18 49.93 percent disallowance of EEI dues was ordered (Ex. S-58, at 38-39). Mr. Smith contends that
19 lobbying, advocacy or promotional activities should not be paid by customers because those activities
20 do not benefit customers (Ex. S-58, at 18).

21 We agree with Mr. Smith's assessment that the portions of the EEI dues related to legislative
22 and regulatory advocacy, advertising, marketing and public relations should not be included in
23 recoverable test year expenses in this case. We believe Staff raises a valid point regarding the nature
24 of EEI core dues, and whether a higher percentage of such dues should be disallowed as related to
25 activities that are not necessary for the provision of service to UNSE customers. We therefore adopt
26 Staff's position on this issue.

27
28 ¹⁰ *Entergy Arkansas, Inc.*, Docket No. 06-101-U, Order No. 10 (June 15, 2007)

1 A&G Capitalization

2 UNSE and Staff are in agreement that it is appropriate for the Company to increase test year
3 expense by \$301,187 for Administrative and General (“A&G”) Capitalization. UNSE witness Dukes
4 stated that these expenses are related to shared service group administrative costs associated with
5 installation of equipment to serve customers, even though such costs can not be traced directly to
6 individual capital projects (Ex. A-24, at 23). Mr. Dukes disputed RUCO’s contention that adoption
7 of the Company’s proposal would result in a double recovery. He testified that, although a portion of
8 the A&G costs were capitalized, the expenses sought by the Company reflect known and measurable
9 recurring costs that will be incurred by the Company on a going-forward basis (*Id.* at 24).

10 RUCO witness Diaz Cortez claims that, if the Company insists on reclassifying test year
11 capitalized expenses to test year expenses, it should make a corresponding reduction to rate base by
12 the same amount. Otherwise, according to Ms. Diaz Cortez, adoption of the Company’s position will
13 result in a double recovery (RUCO Ex. 10, at 13-14).

14 We believe UNSE has properly supported the reason for its proposed adjustment to test year
15 expenses for A&G Capitalization. As Mr. Dukes explained, the capitalization “rate” change took
16 place after the test year, and it is common for capitalization rates for shared service, operational and
17 construction departments to change over time (Ex. A-25, at 14). We therefore adopt UNSE’s
18 position on this issue.

19 Corporate Cost Allocations

20 During the test year, UNSE incurred, as adjusted, \$710,736 in corporate cost allocations from
21 TEP. Ms. Diaz Cortez testified that certain of these expenses were allocated into categories that
22 RUCO contends should not be recovered from ratepayers: Meals and Entertainment - Discretionary;
23 Travel – Meals and Entertainment; and Advertising – Corporate Relations/Communications. She
24 claims that UNSE’s share of the allocations in these categories is \$10,010 (RUCO Ex. 8, at 28-29).

25 Company witness Dukes asserted that the expenses identified by RUCO are “normal,
26 necessary and recurring expenses related to running a utility” and are not incurred solely or primarily
27 to benefit shareholders (Ex. A-25, at 15). However, because of the “immaterial magnitude” of the
28 amount of the meals portion of RUCO’s proposed disallowance (\$1,823), Mr. Dukes agreed to

1 elimination of that portion of the allocation (Ex. A-24, at 25). He continues to recommend allowance
2 of \$8,187 of expenses in the Advertising – Corporate Relations/Communications category.

3 Consistent with our treatment of the Miscellaneous Expenses identified by RUCO, we believe
4 it is appropriate to grant half of RUCO's proposed disallowance of the expenses ($\$8,187/2 = \$4,094$).

5 Depreciation and Property Taxes for CWIP in Plant in Service

6 Given our rejection of UNSE's request for CWIP, the Company supports Staff's adjustments
7 for depreciation and property tax expenses in the amount of \$26,582 (Ex. S-60, Sched. C-3). Since
8 there is no disagreement on this issue, Staff's recommendation shall be adopted.

9 Customer Call Center Expenses

10 On May 1, 2005, UNSE changed its method of responding to customer calls by implementing
11 a consolidated call center operated by TEP, with a level of costs allocated to UNSE. RUCO witness
12 Moore stated that, prior to May 1, 2005, UNSE operated its call center separately, at a cost of
13 \$321,640 per month (RUCO Ex. 5, at 24). After consolidation of the call center, UNSE began to
14 incur allocated costs of \$362,013 per month (*Id.*). Mr. Moore contends that the dramatic increase in
15 costs due to consolidation is not warranted because the integrated call center provides the same level
16 of customer service quality as was experienced before the transition. He states that because no
17 improvement in quality has occurred, the higher costs associated with the consolidated call center
18 should be disallowed (*Id.* at 25).

19 UNSE witness Thomas Ferry stated that the consolidated call center provides a higher level of
20 service to customers and indicated that the prior individualized system would have required a
21 significant investment in new systems to respond to rapid growth in the Company's service area. Mr.
22 Ferry cited a number of benefits of the consolidated operations, including the ability to handle
23 increased call traffic; expanded service hours; a credit card payment option; call volume tracking
24 ability; and one number availability for gas and electric customers in Mohave and Santa Cruz
25 counties (Ex. A-21, at 3-5).

26 As indicated in Decision No. 70011, we do not believe that the record supports the
27 disallowance sought by RUCO on this issue. RUCO's analysis is based on a simple comparison of
28 complaint data and system costs, but does not consider the underlying reasons why consolidation to a

1 modernized call center was necessary. The Company's witness cited a number of advantages
2 associated with the new call center operations and pointed out that RUCO's proposal fails to account
3 for the significant increase in call volume since the new system was put in place, and does not include
4 recognition of the additional investment that would have been required to update the prior
5 decentralized system of customer service. RUCO's recommendation on this issue is therefore denied.

6 Overhead Line Maintenance

7 By its application, UNSE seeks recovery of test year expenses for overhead line maintenance
8 of \$1,149,853. Although Staff does not oppose this expense item, RUCO contends that a
9 normalization of such expenses should be employed to reduce the level of recovery. RUCO witness
10 Rodney Moore testified that volatility of this expense in prior years supports normalization (RUCO
11 Ex. 5, at 23).

12 Company witness Dukes responded that RUCO's proposed normalization over four years
13 failed to recognize that expenses for 2003 were incurred for a partial year, from UNSE's acquisition
14 of the Company in August 2003. He indicated that from 2004 through 2006, UNSE's first full three
15 years of operation, the average overhead line maintenance expenses averaged \$1,054,000 (Ex. A-24,
16 at 31). Mr. Moore refused to concede this issue in his surrebuttal testimony but, on the witness stand,
17 indicated that RUCO would agree to a three-year normalization of \$1,054,000 (Tr. 853, 881-82).

18 We believe the Company has adequately supported the reasonableness of its test year
19 overhead line maintenance expenses. UNSE's expenses were \$916,000 in 2004, \$1,360,000 in 2005,
20 and 1,010,000 in 2006 (Tr. 881-82). Test year expenditures were within a range of reasonableness
21 that is likely to be incurred on a going-forward basis. We therefore decline to adopt RUCO's
22 recommendation on this issue.

23 Southwest Energy Services Markup

24 In his direct testimony, Staff witness Ralph Smith testified that an affiliate of UNSE,
25 Southwest Energy Services ("SES") provides "supplemental work force services" to UNSE and other
26 affiliates. He stated that SES performs supplemental meter reading services for UNSE at a 10 percent
27 markup on base wages of the supplemental workers, plus the cost of the employer's taxes, workers'
28 compensation and benefits (Ex. S-56, at 42). Mr. Smith indicated in his pre-filed testimony that the

1 markup amount should be disallowed because SES is an affiliate company, but that Staff was waiting
2 for additional data responses to quantify the amount of the recommended expense reduction (*Id.*). In
3 his surrebuttal testimony, Mr. Smith stated that \$10,906 of such expenses should be eliminated for
4 SES markups, and that this amount may be understated (Ex. S-58, at 41).

5 UNSE argues on brief that the proposed disallowance should be rejected because it “was first
6 introduced in Mr. Smith’s Surrebuttal Testimony” and “Staff presented no evidence that the cost
7 incurred was unreasonable” (UNSE Initial Brief, at 36).

8 The Company’s claim that Staff did not raise the issue prior to its surrebuttal testimony is
9 simply inaccurate. As described above, Mr. Smith identified the issue in his direct testimony and
10 indicated that Staff was awaiting additional information from the Company prior to quantifying the
11 amount. Once that information was received, Mr. Smith quantified the amount through his
12 surrebuttal testimony.

13 We agree with Staff that a markup by affiliate companies for work performed for a regulated
14 utility should not be recovered through rates paid by captive customers. The issue of affiliate
15 company profits was recently addressed in two Orders involving companies operated by Algonquin
16 Water Resources of America. In Decision No. 69164 (December 5, 2006), we adopted Staff’s
17 recommendation to disallow a portion of costs incurred by Black Mountain Sewer Company (“Black
18 Mountain”) for services performed by an affiliated service company. We stated in that Order that it
19 was inappropriate for Black Mountain to pay its affiliate a “profit margin” (*i.e.*, markup) for services
20 performed by the affiliate (*Id.* at 17-19). We made the same finding with respect to a sister utility
21 company, Gold Canyon Sewer Company (“Gold Canyon”), in Decision No. 69664 (June 28, 2007).
22 In both Decisions, we indicated that it is unreasonable for an affiliate that performs work under an
23 agreement not negotiated at arms length to add an additional margin of profit. There is not sufficient
24 evidence in the record to ascertain the circumstances underlying the arrangement between UNSE and
25 SES, including whether their agreement was openly bid or conducted in an arms-length manner.
26 After Staff’s testimony was filed raising the issue of affiliate markups, it was incumbent upon UNSE
27 to provide additional information regarding the reasonableness of the affiliate markup arrangement.

1 Having failed to do so, we believe Staff's recommendation is appropriate. For these reasons, we
2 adopt Staff's recommendation to remove \$10,906 from test year expenses for UNSE.

3 Miscellaneous "Unnecessary" Expenses

4 RUCO witness Rodney Moore presented testimony requesting that the Company's test year
5 expenses should be reduced by \$73,620 for expenses that were "questionable, inappropriate and/or
6 unnecessary" (RUCO Ex. 5 at 22). Mr. Moore claims that his proposed adjustment is related to
7 payments made to chambers of commerce and non-profit organizations and for donations; club
8 memberships; gifts; awards; extravagant corporate events; advertising, and various meals, lodging
9 and refreshments (*Id.*). He cites a sampling of the 336 questionable expenses, which include \$746 for
10 a barbecue grill, \$608 for flags, \$8,078 for refreshments, \$1,377 for various Chambers of Commerce,
11 and \$1,126 for chartered bus tours (*Id.*).

12 In response to RUCO's claims, UNSE witness Thomas Ferry testified that the expenses
13 questioned by RUCO were appropriately incurred business expenses. He stated that purchases from
14 Walgreens, WalMart or Home Depot were for office supplies or small tools and hardware. Mr. Ferry
15 also claims that meals in restaurants or food brought into the office were incurred for business
16 reasons or during employee training, and that the barbecue grill identified by Mr. Moore was
17 purchased for employee appreciation hamburger lunches as a reward following a severe storm
18 season. Finally, Mr. Ferry contends that air travel expenses between Tucson and Kingman are
19 justified to avoid long single-day round trips and overnight stays (Ex. A-21, at 6-7).

20 As we stated in the recent UNS Gas case (Decision No. 70011, at 24-26), this issue is very
21 similar to the position taken by Southwest Gas in its last rate case, wherein its witness attempted to
22 deflect the burden of proving the reasonableness of Southwest Gas's claimed expenses for a number
23 of "small ticket" items including jeep tours, balloon rides, club memberships, charitable donations,
24 sports events, barbecues, flowers, and various food and drinks expenses. In that case, the Southwest
25 Gas witness agreed to exclude what she perceived to be clearly inappropriate miscellaneous
26 expenses, but indicated that many of the expenses were too small for even the company to determine
27 whether they should be included in cost of service. Southwest Gas's witness therefore concluded that
28 RUCO had not presented sufficient evidence to support its proposed disallowance.

1 Here, UNSE attempted to justify several of the expenses identified by RUCO, in a general
2 sense, but did not address many of the specific expenses categories raised in Mr. Moore's testimony.
3 For example, Mr. Ferry indicated that expenses incurred at stores such as Walgreens, WalMart or
4 Home Depot are legitimate business expenses, and that employee recognition expenses should be
5 recoverable through rates, but he did not respond directly to most of the specific expense categories
6 described in RUCO's testimony. As set forth in Mr. Moore's surrebuttal testimony, RUCO contends
7 that ratepayers should not be responsible for Company expenses in categories such as: liquor, coffee,
8 water, bagels, donuts, sandwiches; flowers, sympathy cards, gift certificates, photographs; charitable
9 and service club donations; recognition events, sports events, and club memberships; and numerous
10 purchases made from Circle K, Walgreens, WalMart, Basha's, Frys, and Safeway (RUCO Ex. 7, at
11 14).

12 In both the UNS Gas and Southwest Gas Decisions, we rejected the argument that RUCO
13 must prove the unreasonableness of individual expenses. As we stated in Decision No. 68487, "[i]t is
14 curious that Southwest Gas seeks to cast the burden of proving the unreasonableness of expenses on
15 RUCO, especially once RUCO has provided some evidence that certain claimed expenses are
16 inappropriate and which evidence, by the Company's own admission, should result in additional
17 exclusions" (*Id.* at 21).

18 Consistent with the UNS Gas and Southwest Gas Decisions, we find that a portion of the
19 claimed expenses in this "miscellaneous" category should be disallowed. As we stated in the UNS
20 Gas case, "[w]hile it may seem unfair for a utility company to be required to come forward with
21 supporting evidence regarding the reasonableness of even small expenses, when the Company is
22 seeking to place the burden of such expenses exclusively on the backs of its customers, it is required
23 to prove that the expenses were reasonably necessary for the provision of service to those customers."
24 (Decision No. 70011, at 25). Consistent with the UNS Gas and Southwest Gas Orders, because many
25 of the expenses appear to be legitimate expenses related to items such as training and maintenance,
26 we will disallow half of RUCO's proposed amount ($\$73,620 \times 50\% = \$36,810$).

27 ...

28 ...

1 Valencia Turbine Fuel

2 UNSE proposed an adjustment of \$266,198, to include the cost of fuel to operate its Valencia
3 Turbines. RUCO witness Marylee Diaz Cortez testified that data responses received from UNSE
4 indicated that the Valencia fuel costs were included in the test year Purchased Power Fuel Adjustor
5 Clause ("PPFAC"), but the Company proposes to transfer recovery of these fuel costs to base rates on
6 a pro forma basis. Ms. Diaz Cortez contends that the proposed treatment would result in a double
7 recovery because UNSE is seeking to increase base rates for recovery while, at the same time,
8 passing the Valencia fuel costs through the PPFAC (RUCO Ex. 10, at 29-30). RUCO therefore
9 recommends removal of \$266,198 from the Company's pro forma operating expenses.

10 UNSE witness Dallas Dukes claims that there would be no double recovery under the
11 Company's proposal. According to Mr. Dukes, the ultimate actual cost of providing energy to
12 customers is all that will be passed on to customers, and the addition of Valencia fuel costs to test
13 year expense would more accurately reflect the base cost of fuel, purchased power and purchased
14 energy on a going-forward basis (Ex. A-24, at 26). He added that UNSE's proposal is intended only
15 to set the base cost, but ultimately the actual cost would go into a deferred regulatory account and
16 customers would be charged only the approved base rate of fuel, purchased power and purchased
17 transmission, and any applicable PPFAC charges in the future, and no double recovery would occur
18 (*Id.*). Staff did not oppose the Company's proposed adjustment.

19 We agree that the UNSE's proposal would not result in a double recovery of fuel expenses
20 from customers because, as explained by Mr. Dukes, only the known and measurable amount
21 incurred during the test year would be used to establish a representative base power supply rate, and
22 only the actual Valencia fuel costs would be recovered from ratepayers (Ex. A-25, at 15-16).
23 RUCO's proposal on this issue is therefore denied.

24 M.A.R.C. Training

25 RUCO proposed removal of \$14,251 related to costs incurred by UNSE during the test year
26 for a Management Associated Results Company ("M.A.R.C.") training. RUCO witness Moore stated
27 that these training expenses were for a one-time only training program for union employees, and
28 should therefore be disallowed (RUCO Ex. 7, at 17). At the hearing, Mr. Moore indicated that if the

1 Company provided a late-filed exhibit showing that such training expenses are recurring, RUCO
2 would agree not to make its proposed adjustment (Tr. 899).

3 UNSE responded by presenting an exhibit at the hearing showing when M.A.R.C. training
4 took place, and when it is scheduled to take place in the future (Ex. A-59; Tr. 1358). In its reply
5 brief, RUCO stated that it is withdrawing its proposed adjustment related to the training (RUCO
6 Reply Brief, at 9).

7 Outside Services for Demand Side Management ("DSM") Program

8 RUCO witness Diaz Cortez testified that, during the test year, UNSE paid ECOS Consulting
9 ("ECOS") \$49,920 to develop the Residential New Construction DSM Program (Energy Smart
10 Homes). She indicated that, because future DSM costs will be recovered through a DSM adjustor
11 surcharge, the amount paid to ECOS should disallowed (RUCO Ex. 8, at 30).

12 UNSE witness Dukes agreed that \$49,920 should be removed from test year expenses.
13 However, he stated that \$32,865 had previously been eliminated from the Company's expenses and,
14 therefore, an additional reduction of only \$17,055 is necessary (Ex. A-24, at 27). In his rejoinder
15 testimony, Mr. Dukes offered additional details regarding this issue, and provided RUCO with
16 supporting workpapers (Ex. A-25, at 16-18).

17 In its brief, RUCO agreed that, after reviewing the workpapers provided by the Company, the
18 appropriate adjustment should be limited to \$17,055 (RUCO Initial Brief, at 20).

19 Depreciation and Amortization Expense

20 In its application, UNSE proposed a positive pro forma adjustment of \$582,986 to
21 depreciation and amortization expense. Staff witness Ralph Smith recommended a downward
22 adjustment to this amount of \$63,105, for a net pro forma depreciation and amortization adjustment
23 of \$519,881 (Ex. S-60, Sched. C-15).

24 In her rebuttal testimony, Ms. Kissinger acknowledged that Staff's adjustment was
25 appropriate to reconcile an error in the Company's depreciation study with respect to transportation
26 equipment (Ex. A-12, at 2). She added, however, that an additional adjustment proposed by RUCO
27 should not be adopted because it did not recognize that a portion of transportation depreciation is
28 capitalized (*Id.*).

1 In his surrebuttal testimony, RUCO witness Rodney Moore stated that "RUCO agrees with
2 the Company to accept Staff's adjustment" (RUCO Ex. 7, at 11). Despite RUCO's concession prior
3 to the start of the hearing, UNSE argues on brief that "RUCO's proposed adjustment is incorrect and
4 should not be adopted" based on Ms. Kissinger's prior rebuttal testimony (UNSE Initial Brief, at
5 38)¹¹. Despite UNSE's request to deny RUCO's recommendation, we assume the Company does not
6 oppose RUCO's revised position.

7 Property Tax Expense

8 Both Staff and RUCO recommended setting allowable expenses for property tax based on a
9 rate of 23.5 percent. Staff witness Ralph Smith testified that Staff's recommendation is based on the
10 known and measurable assessment for 2008, pursuant to legislation passed by the Arizona State
11 Legislature that reduces property tax assessments from a rate of 25 percent in 2005, by 0.5 percent in
12 each successive year, until a rate of 20 percent is achieved in 2015 (Ex. S-56, at 31-33). Mr. Smith
13 stated that the Company's initial proposal fails to recognize the impact of the known tax change. He
14 also indicated that Staff's recommendation is consistent with the recent Southwest Gas rate case
15 (which had a test year ending August 31, 2004), wherein Southwest Gas, Staff, and RUCO agreed
16 that a 24.5 percent assessment for the 2006 rate was appropriate for the calculation of property tax
17 expense (*Id.*)¹². RUCO witness Rodney Moore also proposed use of a 23.5 percent assessment rate
18 for UNSE in this case, based on the same rationale described by Mr. Smith (RUCO Ex. 7, at 12).

19 UNSE initially proposed the use of a property tax rate of 24.0 percent but subsequently agreed
20 that the 23.5 percent rate that became effective January 1, 2008 should be used for setting rates in this
21 proceeding (Ex. A-12, at 2-3).

22 We agree with the parties that the property tax expense allowance in this case should be based
23 on the known and measurable assessment rate currently in effect. The rate for 2008 is 23.5 percent,
24 and the rate will continue to decline in subsequent years while the rates established in this case are in
25 effect.

26 ¹¹ It appears that the Company's brief failed to recognize responsive testimony filed after that of its own witness, which
27 responsive testimony expressed agreement with the Company's position. Indeed, RUCO did not address this issue in its
brief, presumably because RUCO properly assumed that the issue was resolved.

28 ¹² The recent UNS Gas Decision set the property tax rate at 24.0 percent to reflect the rate in place when the Decision
became effective (Decision No. 70011, November 27, 2007, at 32).

1 Income Tax Expense

2 UNSE proposed allowance of income tax expense of approximately \$4.8 million based on the
3 Company's recommended revenue requirement. Company witness Kissinger stated that UNSE's
4 computation of pro forma income tax expense for current and deferred portions identifies all book-tax
5 accounting differences, because non-cash deferred income taxes are shown separately from current
6 income taxes in the Company's lead-lag study for working capital. She indicated that the Company's
7 treatment of income taxes also ensures that all IRS normalization requirements are met (Ex. A-12, at
8 11-12).

9 RUCO witness Diaz Cortez disagreed with UNSE's methodology for calculating income tax
10 expense, stating that it is standard practice in ratemaking to account for income tax expense on a
11 current basis, because the accounting for tax timing differences is reflected for ratemaking purposes
12 in the Company's rate base (RUCO Ex. 10, at 18). According to Ms. Diaz Cortez, tax timing
13 differences that are assets are reflected as rate base additions, while timing differences that are
14 liabilities are treated as reductions to rate base. RUCO therefore disagrees with the Company's
15 proposal on this issue (*Id.*).

16 In her rejoinder testimony, Ms. Kissinger responded that RUCO's proposed methodology
17 does not accurately describe the ratemaking process, because revenue requirements are based on an
18 income tax expense component that includes both current and deferred elements and some of the
19 most contentious ratemaking issues involve determination of the deferred component of income tax
20 expense. Ms. Kissinger claims that Section 168(i)(9)(B) of the Internal Revenue Code states that
21 normalization requirements are violated if a procedure or adjustment that is inconsistent with the
22 normalization requirements is used for ratemaking (Ex. A-13, at 3-4).

23 We believe the Company's explanation of the basis for its income tax expense methodology is
24 reasonable. Ms. Kissinger explained that it is necessary to account separately for current and
25 deferred components of the expense for ratemaking purposes to establish a proper revenue
26 requirement, and that the IRS requires consistency with the ratemaking normalization procedures in
27 order to comply with the requirements of the Internal Revenue Code. We therefore reject RUCO's
28 proposed adjustment on this issue.

1 Interest Synchronization

2 There does not appear to be any dispute that an interest synchronization adjustment is
3 necessary to coordinate the income tax calculation with rate base and cost of capital. As set forth in
4 Staff witness Ralph Smith's testimony, this adjustment decreases income tax expense and increases
5 the Company's achieved operating income by a similar amount (Ex. S-56; Ex. S-60, Sched. C-14).

6 New Depreciation Rates

7 Staff witness Ralph Smith indicated that Staff is in agreement with the Company's proposed
8 new depreciation rates (Ex. S-56 at 68). However, Mr. Smith recommended that each of the new
9 depreciation rates proposed by UNSE should be clearly broken out by a service life and a net salvage
10 rate. He indicated that this would allow the depreciation expense related to the inclusion of estimated
11 future cost of removal in depreciation rates to be tracked and accounted for by plant account (*Id.*).
12 There does not appear to be a dispute regarding the new depreciation rates to be employed by UNSE.
13 Further, the Company did not oppose Mr. Smith's suggestions for separating the depreciation rates
14 for service life and net salvage. Staff's recommendation is therefore adopted.

15 Net Operating Income

16 Consistent with the foregoing discussion, we find adjusted test year operating expenses were
17 \$149,205,544, which based on test year revenues of \$158,539,827, resulted in test year adjusted
18 operating income of \$9,334,283, a 5.57 percent rate of return on FVRB.

19 **COST OF CAPITAL**

20 UNSE recommends that the Commission determine the Company's cost of common equity to
21 be 11.80 percent, with an overall weighted cost of capital recommendation of 9.89 percent (UNSE
22 Final Schedules, Sched. D-1). Staff recommends a cost of common equity of 10.0 percent, with an
23 overall weighted cost of capital determination of 8.99 percent (Ex. S-60). RUCO proposes adoption
24 of a cost of common equity of 9.30 percent, with an overall weighted cost of capital of 8.67 percent
25 (RUCO Ex. 13 at 6).

26 Capital Structure and Cost of Debt

27 As explained by Staff witness David Parcell, a regulated utility company's capital structure
28 (the ratio of debt and equity) is important in setting rates based on an estimate of the company's total

1 cost of capital. He stated that the regulator must determine whether the given utility's capital
2 structure is appropriate relative to its level of risk and relative to other utilities (Ex. S-52, at 15)

3 In this case, UNSE proposes using a capital structure consisting of 47.18 percent long-term
4 debt, 3.97 percent short-term debt, and 48.85 percent equity (Ex. A-34 at 8) which, according to
5 Staff, represents the Company's actual capital structure as of June 30, 2007. Staff, however,
6 recommends using the actual end of test year capital structure (June 30, 2006) which is comprised of
7 48.83 percent common equity, 47.21 percent long-term debt, and 3.96 percent short-term debt (Ex. S-
8 52, at 17-18, Ex. DCP-1). Staff further recommends a cost of long-term debt of 8.16 percent and a
9 cost of short-term debt of 6.36 percent (*Id.*). The Company's proposed rates are 8.22 percent for
10 long-term debt and 6.36 percent short-term debt (Ex. A-52, at 3).

11 The slight difference between the UNSE and Staff recommendations is due to the time at
12 which the snapshot of actual capital structure is taken. Based on the testimony and evidence
13 presented, we believe the Company's proposal to use the capital structure as of June 30, 2007 is
14 appropriate because it provides a more accurate measurement of the capital structure at the time the
15 rates set in this proceeding will be in effect. We therefore adopt a capital structure consisting of
16 47.18 percent long-term debt, 3.97 percent short-term debt, and 48.85 percent equity, with rates of
17 8.22 percent for long-term debt and 6.36 percent short-term debt.

18 Cost of Common Equity

19 Determining a company's cost of common equity for purposes of setting its overall cost of
20 capital requires an estimate based on a number of factors. As is seen in the discussion below,
21 determining a regulated entity's cost of common equity is as much an art as a science, and requires a
22 feat of prognostication that would likely cause even the Oracle of Delphi to shudder with trepidation.
23 There is no fool-proof methodology for making this determination, and the expert witnesses rely on
24 various analyses to support their respective recommendations.

25 UNSE

26 UNSE witness Kentton Grant based his common equity cost recommendation of 11.80
27 percent on the results of his common equity models, namely the Discounted Cash Flow ("DCF") and
28 Capital Asset Pricing Model ("CAPM"). Mr. Grant also examined the risk profile of UNSE relative

1 to a comparable company group to determine a point in the range produced by those models. The
2 estimated cost of equity produced by this analysis was then compared to the allowed returns for other
3 electric utilities in the United States to confirm the reasonableness of the Company's estimate. As a
4 final matter, Mr. Grant examined the financial impact of the recommended return on equity ("ROE")
5 and the overall rate request to assess the Company's ability to attract capital on reasonable terms (Ex.
6 A-52 at 9).

7 Mr. Grant claims that it was appropriate to use a comparable group of electric companies in
8 his analysis because the assets of UNSE's parent company, UniSource Energy, are heavily weighted
9 toward TEP, which has a much larger investment in facilities and has a case pending before the
10 Commission regarding the deregulated status of those facilities (*Id.* at 10). Therefore, according to
11 Mr. Grant, the cost of equity capital for UniSource Energy or TEP may not be representative of the
12 cost of equity for UNSE (*Id.*). Mr. Grant's comparable group was based on approximately 60 electric
13 companies evaluated by *Value Line Investment Survey* ("*Value Line*"), from which 8 companies were
14 selected based on several criteria that Mr. Grant believes make them comparable to UNSE (*Id.*).

15 Mr. Grant explained that the DCF methodology is based on the theory that the price of a share
16 of stock is equal to the present value of all future dividends. As described by Mr. Grant, the constant
17 growth form of the DCF model recognizes that the return to shareholders consists of both dividend
18 yield and growth. He stated that the constant growth form of the model should not be used for
19 companies with near-term growth rates that are significantly higher or lower than their long-term
20 growth potential. For such companies, Mr. Grant claims that a multi-stage DCF model should be
21 used to incorporate the various growth rates that are expected over time (*Id.* at 11-13).

22 According to Mr. Grant, an annual long-term growth rate of 6.5 percent represents a
23 reasonable estimate of investor expectations for earnings and dividends, which he claims is consistent
24 with the 6.0 to 7.5 percent growth rate range in earnings per share ("EPS") for his comparable
25 company group published by *Value Line*, as well as a five-year estimate of EPS growth reported by
26 *Reuters and Zacks* of 8.0 and 8.6 percent, respectively, for the electric utility industry (*Id.* at 15).
27 Based on his application of a multi-stage DCF model, the estimated cost of equity for the sample
28

1 companies produced a range of 9.7 percent to 10.5 percent, with a median value of 10.4 percent (*Id.*
2 at 16).

3 Mr. Grant stated that use of the CAPM is premised on the concept that capital markets are
4 highly efficient and that investors attempt to optimize their risk/return profiles through
5 diversification. He indicated that the CAPM assumes that risk is comprised of systematic risk (which
6 is unavoidable) and unsystematic risk (which is company-specific and can theoretically be eliminated
7 through portfolio diversification). As a result, Mr. Grant explained that the CAPM is based on the
8 theory that investors should be compensated only for systematic risk (*Id.* at 17). Applying the CAPM
9 produced a result of 9.8 percent to 11.2 percent. Based on his comparison of the DCF and CAPM
10 results, Mr. Grant selected a range of 9.7 percent to 11.2 percent as the Company's estimate of the
11 cost of equity for the comparable company group (*Id.* at 19).

12 The next step in the Company's analysis was to determine the appropriate return on equity in
13 this proceeding for UNSE, based on a comparison of the "risk profiles" of UNSE and the comparable
14 companies. Mr. Grant asserts that an equity investment in UNSE is "decidedly riskier" than an
15 equity investment in the comparable companies due to several factors, including UNSE's smaller
16 size, a higher customer growth rate, the \$60 million maturity of long-term debt in 2008, and the need
17 to procure a new power supply by mid-2008. Based on these relative risk factors, Mr. Grant proposes
18 that a 60 basis point equity risk premium should be applied to UNSE, resulting in a cost of equity
19 range of 10.3 to 11.8 percent. He stated that the ROE for UNSE should be set at the top of the range
20 for comparable companies, and that the Commission should award a ROE of 11.80 percent in this
21 proceeding (*Id.* at 20-23).

22 UNSE criticizes Staff's and RUCO's ROE recommendations based on the Company's claim
23 that the results fail a basic test of reasonableness. UNSE contends that Staff's (10.0 percent ROE)
24 and RUCO's (9.30 percent ROE) recommendations are below ROEs approved by other state
25 commissions and that UNSE bears much greater risk than comparable companies due to the factors
26 cited in Mr. Grant's testimony. Based on the Company's higher risk assertion, it claims it must be
27 awarded a higher ROE commensurate with that risk.

1 UNSE is also critical of Staff's use of a geometric means in calculating the market risk
2 premium. UNSE argues that an arithmetic means is supported by academics and financial
3 professionals. The Company also contends that RUCO's analysis placed too much emphasis on near-
4 term analyst growth forecasts, a methodology that UNSE contends has been rejected by the
5 Commission in two recent cases. UNSE is also critical of RUCO's use of a single-stage DCF model,
6 which assumes that company growth rates will continue in perpetuity, and of RUCO's over-reliance
7 on analyst forecasts.

8 RUCO

9 RUCO witness William Rigsby proposes adoption of a ROE of 9.30 percent based on his
10 analysis using DCF and CAPM methodologies (RUCO Ex. 13, at 8). As noted above, Mr. Rigsby
11 employed a single-stage DCF analysis, as opposed to the multi-stage version used by UNSE.

12 RUCO is critical of Company witness Grant's DCF model, which RUCO claims assumes a
13 long-term growth rate that would be comparable to an inflation-adjusted growth rate for all goods and
14 services produced by labor and property in the United States in perpetuity. According to Mr. Rigsby,
15 a valid argument could be made that regulated utility company growth rates may not be comparable
16 to national Gross Domestic Product ("GDP") growth rates, and therefore, the multi-stage DCF
17 advocated by UNSE is inappropriate (RUCO Ex. 14, at 11-12). Mr. Rigsby also stated that the
18 multi-stage DCF used by the FERC requires more weight to be given to short-term growth
19 expectations rather than inflation-adjusted estimates of future GDP growth (*Id.*). Mr. Rigsby pointed
20 out that FERC's reasoning is based on the theory that short-term estimates, similar to those employed
21 by Mr. Rigsby's single-stage DCF model, are more predictable and warrant more weight than the
22 estimates derived from the Company's unweighted multi-stage DCF model (*Id.*).

23 RUCO also disagrees with UNSE regarding the effect that customer growth should have on
24 the Company's return on equity. Contrary to the Company's claim that high growth presents
25 additional risk that must be reflected through a higher authorized return, RUCO argues that high
26 growth in Arizona is a positive factor that should be a selling point to UniSource investors. RUCO
27 cites to UniSource's 2005 Annual Report, in which its Chairman touted the company's customer
28 growth rate as a positive factor (*Id.* at Attach. C). RUCO also notes that UniSource's stock price has

1 increased since its acquisition of Citizens which, according to Mr. Rigsby, shows that investors do
2 not regard high growth service areas as a negative factor (*Id.* at 14).

3 Staff

4 Staff witness David Parcell presented Staff's ROE recommendation in this case. In
5 developing his recommendation, Mr. Parcell utilized DCF, CAPM, and Comparable Earnings
6 Method ("CEM") analyses. He indicated that, because UNSE is not publicly traded, it is not possible
7 to directly apply cost of equity models. In his analysis, Mr. Parcell employed 2 comparable groups of
8 companies as a proxy for UNSE Gas (Ex. S-52, at 18-19). The first sample group was comprised of a
9 group of nine combination gas and electric companies and the second group consisted of the same 8
10 electric companies used by the Company's witness.

11 Mr. Parcell's DCF analysis produced a range of 9.50 percent to 10.5 percent for the proxy
12 groups' cost of equity. His CAPM model produced a cost of equity range of approximately 10.0
13 percent to 10.50 percent for the sample groups (*Id.* at 26). Mr. Parcell also utilized a CEM analysis,
14 which he described as a method designed to measure the returns expected to be earned on the original
15 cost book value of similar risk companies. According to Mr. Parcell, his CEM analysis was based on
16 market data using market-to-book ratios, and is therefore a market test that should not be subject to
17 criticisms leveled at other analyses that are based on past earned returns. He also claims that the
18 CEM uses prospective returns and is therefore not backward-looking (*Id.* at 26-30). Using the CEM,
19 Mr. Parcell concluded that the cost of equity for the proxy companies is "no more than 10 percent"
20 (*Id.* at 29).

21 Based on the results of the three methodologies, Mr. Parcell found an overall range of 9.5
22 percent to 10.5 percent ROE for the proxy companies. He indicated that the range of mid-points for
23 the three methodologies is 10.0 percent to 10.25 percent. Mr. Parcell concluded that the appropriate
24 cost of equity rate for UNSE is in the range of 9.5 percent to 10.5 percent. He recommended that the
25 Commission adopt the mid-point of the range (10.0 percent) as the ROE in this case (*Id.* at 30).

26 With respect to the arguments raised by the Company, Staff asserts that UNSE failed to give
27 any weight to its own DCF analysis and relied exclusively on its excessive CAPM results. Staff
28 contends that UNSE's CAPM analysis is flawed because it is based on a result of 9.8 percent to 11.2

1 percent, but only one company in the sample group, UIL Holdings, had a CAPM result in excess of
2 11 percent. Staff contends that not only did Mr. Grant choose the highest point of the CAPM group
3 in determining his result, he added 60 basis points to that result to support his 11.80 percent ROE
4 recommendation.

5 In response to the Company's criticism of Staff's use of geometric means in its analysis, Staff
6 cites to Mr. Parcell's surrebuttal testimony, wherein he indicated that investors have access to both
7 arithmetic and geometric returns in making investment decisions and that many mutual fund investors
8 rely on geometric returns in evaluating historic and prospective returns of funds (Ex. S-53 at 2-3).
9 Staff also criticized the Company's use of an inappropriate equity risk premium of 7.1 percent, which
10 is based exclusively on the arithmetic means of common stock and bond returns from 1926 to 2005
11 (*Id.* at 32). Staff points to Mr. Parcell's testimony indicating that *Value Line* reports show historic
12 returns based on a geometric or compound growth rate basis (*Id.* at 33).

13 Conclusion on Cost of Equity

14 Having considered the testimony, exhibits, and arguments, we believe that Staff's
15 recommended cost of equity capital produces a reasonable result and should be adopted. Staff
16 witness Parcell's proposed 10.0 percent cost of equity provides a reasonable balance between the
17 Company's attempt to place the ROE at the very top of the range produced by the Company's
18 analysis and the results achieved through the methodologies employed by Staff and RUCO.

19 As noted above, Mr. Parcell's DCF analysis produced a range of 9.5 percent to 10.5 percent
20 for the proxy groups' cost of equity, his CAPM model produced a cost of equity range of 10.0
21 percent to 10.5 percent for the sample groups, and his CEM analysis produced a result for the proxy
22 companies of no more than 10 percent. Based on his conclusion that UNSE has an estimated ROE of
23 9.5 to 10.5 percent, Mr. Parcell recommended awarding the Company a ROE at the mid-point of the
24 range, or 10.0 percent.

25 We agree with Staff that it is appropriate to consider the geometric returns in calculating a
26 comparable company CAPM because to do otherwise would fail to give recognition to the fact that
27 many investors have access to such information for purposes of making investment decisions.

28

Although there continues to be disagreement regarding the risk effect from high customer growth, we believe that high growth has the potential for providing benefits through increased revenues.

Accordingly, we adopt Staff's recommended 10.0 percent ROE in this proceeding for UNSE, which results in an overall weighted average cost of capital of 9.02 percent.

	<u>Percentage</u>	<u>Cost</u>	<u>Avg. Weighted Cost</u>
Common Equity	48.85%	10.0%	4.89%
Long-Term Debt	47.18%	8.22%	3.88%
Short-Term Debt	3.97%	6.36%	.25%
			9.02%

Chaparral City Decision and Fair Value Rate Base

In its application, UNSE proposed that the weighted average cost of capital ("WACC") should be applied to its original cost rate base to determine the required operating income in this case (Ex. A-1, Sched. A-1). However, in the rebuttal testimony submitted by UNSE witness Grant, the Company made the claim that its WACC should be applied to FVRB. UNSE claims that its change of position was based on its understanding of a recent Memorandum Decision issued by the Arizona Court of Appeals in *Chaparral City Water Co. v. Ariz. Corp. Comm'n*, 1 CA-CC 05-0002 (Ariz. App. Feb. 13, 2007) ("*Chaparral City*"). According to Mr. Grant's rebuttal testimony, UNSE is not requesting that its change of position result in a revenue requirement finding that would exceed the amount originally requested by the Company (Ex. A-35 at 33).

UNSE argues that in the Chaparral City case before the Commission, the Commission adopted Staff's recommendation to calculate the revenue requirement by multiplying OCRB by the cost of capital (Decision No. 68179, at 26-28). UNSE claims that only after this exercise was completed did Staff calculate the FVRB for Chaparral City, which resulted in what UNSE contends is a "backing-in" approach because the FVRB calculation is a meaningless exercise that flows from the OCRB and cost of capital equation. UNSE witness Grant asserted that the approach advocated by Staff in this case is mathematically equivalent to the methodology used in the Chaparral City case and rejected by the Court of Appeals (Ex. A-35, at 33).

In support of its argument, UNSE cites to Article 15, §14 of the Arizona Constitution, which states in part that "[t]he Corporation Commission shall, to aid it in the proper discharge of its duties,

1 ascertain the fair value of the property within the State of every public service corporation doing
2 business therein..." UNSE cites several cases¹³ in support of its argument that the Commission is
3 required to determine a company's fair value rate base and use that rate base in establishing the
4 company's rates. UNSE concedes that its proposal to apply the WACC to FVRB is not the only
5 possible approach to setting rates, but suggests that it is the only approach presented in this case that
6 complies with the Arizona Constitution. The Company claims that other permissible methods may be
7 developed in future cases but, for now, the UNSE methodology is the only available choice for the
8 Commission to apply.

9 Staff argues that the Company's reliance on the unpublished *Chaparral City* decision is
10 misplaced. Staff contends that the Court of Appeals specifically indicated that the Commission was
11 not required to apply the WACC to FVRB in order to set rates, and that the methodology proposed by
12 Mr. Grant would result in an unreasonable and excessive return on equity for UNSE. Staff cites to
13 Mr. Parcell's testimony addressing the Company's proposal, wherein he testified that, under UNSE's
14 proposal, the link between rate base and capital structure would be broken because the "excess" of
15 fair value rate base over original cost rate base is not financed with investor-supplied funds, and
16 therefore the cost of capital cannot be applied to the fair value rate base because there is no financial
17 link between the two concepts (Ex. S-52 at 37). Mr. Parcell's proposed solution is to recognize that
18 the difference between FVRB and OCRB is not financed with investor funds by attributing no cost to
19 the excess between the two. He stated that this recommendation would provide for a return being
20 earned on all investor-supplied funds, which is consistent with sound financial and regulatory
21 standards (*Id.* at 38).

22 Staff contends that there is no evidence that investors expect such an excess return and that
23 the record supports an opposite conclusion. Staff asserts that the difference between applying the
24 return to OCRB and FVRB would be, in effect, a windfall on unrealized paper profits. Staff claims
25 that Mr. Parcell's proposal to assign no cost to the "excess" between OCRB and FVRB is logical and
26

27 ¹³ *U.S. West Communications, Inc. v. Ariz. Corp. Comm'n*, 201 Ariz. 242, 246, 34 P.3d 351, 355 (2001); *Simms v. Round*
28 *Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956); *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531,
533-534, 578 P.2d 612, 614-615 (App. 1979); *Phelps Dodge Corp. v. Arizona Electric Power Co-op*, 207 Ariz. 95, 83
P.3d 573, 586 (App. 2004).

1 consistent with investor expectations. Staff argues that, to the extent that investors may expect a
2 return on the so-called paper profits, such a return is already incorporated into the cost of capital
3 models employed by the experts in this case.

4 In Decision No. 70011 (at pages 45-51) we cited several decisions rendered in other states
5 which recognized the problem of applying the cost of capital to fair value rate base¹⁴. Consistent
6 with the problems identified by Mr. Parcell, application of modern cost of capital models, such as
7 DCF and CAPM, directly to FVRB would create redundancies and double counting. In the UNS Gas
8 Order, we cited to the case of *Railroad Commission of Texas v. Entex, Inc.*, 599 S.W.2d 292 (Tx.
9 1980), in which the Texas Supreme Court discussed the so-called "backing-in" method of
10 determining fair value rate of return. In that case, the court stated that "[i]n a fair value jurisdiction
11 the rate of return multiplied by the rate base usually resulted in a higher return to the book common
12 equity than in an original cost jurisdiction because of the inclusion of the reproduction cost new
13 factor." (*Id.* at 298). In rejecting the "backing-in" argument presented by the utility company, the
14 Texas Supreme Court observed that, in fair value jurisdictions, the return to book common equity is
15 used as a performance indicator by investors, and that fact could not be ignored by blindly applying a
16 rate of return to fair value rate base without recognizing the consequences of such a rate of return on
17 the elements of the company's capital structure. The court also stated:

18 [T]he fairness of the rate base or the rate of return can be measured by the
19 cash requirements of the utility. All are interdependent and ultimately
20 need to be reconciled....a return to book common equity which is out of
21 proportion...cannot be ignored since it is more than necessary to attract
capital, and therefore, unfair to the ratepayer. (*Id.* at 299, emphasis
added).

22 Further, as recognized in the *Entex* case quoted above, the question that must properly be addressed is
23 whether investors expect an additional return in excess of the return resulting from application of the
24 financial models used for calculating the appropriate authorized return.

25
26
27 ¹⁴ In *Re Harbour Water Corporation*, 2001 WL 170550 (Indiana Utility Regulatory Commission); *Gary-Hobart Water*
28 *Corp. v. Indiana Utility Regulatory Comm'n*, 591 N.E.2d 649, 653 (Ind. App. 1992); *State of North Carolina ex rel.*
Utilities Commission et al. v. Duke Power Co., 285 N.C. 377, 397, 206 S.E.2d 269, 294 (N.C. 1974); *State of North*
Carolina ex rel. Utilities Commission et al. v. Virginia Electric and Power, 285 N.C. 398, 206 S.E.2d 283 (N.C. 1974).

1 UNSE attempts to portray its amended proposal as an innocuous placeholder, by claiming that
2 there is no harm due to its willingness to be limited only to the revenue requirement set forth in its
3 original application. However, the underlying premise of the Company's argument is fallacious
4 unless the Commission were to agree with every revenue requirement position advocated by the
5 Company. As discussed above, we have rejected a number of the arguments raised by UNSE. As a
6 result, the Company's revised position regarding application of FVRB, if it were adopted, would have
7 a substantial impact on the rates that are established in this Decision.

8 Moreover, the purpose of the Company's reliance on the cases it cites is unclear, given that no
9 party disputes the concept that fair value rate base must be determined and applied in setting rates.
10 The cases cited by UNSE do not, however, stand for the proposition espoused by the Company (*i.e.*,
11 that the Commission *must* apply the Company's WACC to FVRB to determine just and reasonable
12 rates). In fact, those cases make clear that the Commission, although required to ascertain a
13 company's fair value rate base and use that fair value rate base in determining rates, has broad
14 discretion in how the rate-setting formula should be applied.

15 Even if we were inclined to consider the Company's proposal, its arguments are premature at
16 best. Through his rebuttal testimony, UNSE witness Grant suggests that the Commission must apply
17 the WACC to fair value rate base pursuant to the *Chaparral City* decision (Ex. A-35 at 33).
18 However, Mr. Grant's proposal ignores the explicit language of the Court's decision, which states:
19 "the Commission asserts that it was not bound to use the weighted average cost of capital as the rate
20 of return to be applied to the FVRB. The Commission is correct....[t]he Commission has the
21 discretion to determine the appropriate methodology." (*Chaparral City, supra*, at p. 13, ¶17). Despite
22 this unambiguous explanation, UNSE would have us employ the very methodology the Court of
23 Appeals specifically stated the Commission was not required to apply in setting rates.

24 Aside from the disingenuousness of the Company's argument, the current posture of the
25 *Chaparral City* case is that it has been remanded to the Commission for further consideration. At this
26 point, the Commission has not rendered a decision on the issue remanded by the Court. Once the
27 Commission issues a subsequent order in the remanded case, the Commission's decision may, or may
28 not, be appealed to the Court of Appeals for a determination of compliance with the Court's remand.

1 Thus, entirely aside from the inappropriateness of citing the unpublished *Chaparral City* decision as
2 precedent, using it as the foundation for requiring a specific methodology in another unrelated case is
3 clearly improper given that the Commission has been given an opportunity to cure the perceived
4 defects in the *Chaparral City* case. Until that case has been decided under the Court's remand order,
5 it is premature for UNSE (or any other company) to suggest that the Commission must apply a
6 particular methodology, especially a methodology that the Court specifically stated the Commission
7 is not required to adopt.

8 We also believe that Staff has raised a number of relevant concerns with the Company's
9 attempt to apply the WACC to FVRB without further modification. As Staff points out, there is no
10 logical basis for applying such a methodology because investors have no expectation that they will
11 earn a return on the excess between OCRB, which represents investor supplied funds, and FVRB,
12 which represents unrealized paper profits. If the Company's proposal were to be adopted, the
13 underlying basis of the cost of capital analysis would be called into question and would likely require
14 substantial modification to avoid a result that grants excessive windfall returns to investors at the
15 expense of ratepayers. We note that UNSE states in its brief that, pursuant to the holding in *Ariz.*
16 *Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (1959), the Commission
17 may not consider the argument raised by Staff regarding investor-supplied funds. The *Arizona Water*
18 case is clearly distinguishable from the instant case, however, given the fact that the Court in *Arizona*
19 *Water* was asked to consider only whether a recent purchase price paid for the utility company could
20 be used by the Commission as the fair value of the utility for setting rates. No such set of facts is
21 presented in this proceeding, and we do not believe the *Arizona Water* holding is applicable to the
22 arguments presented by Staff.

23 For all of these reasons, after considering all of the relevant arguments, evidence and factors
24 presented in this proceeding, in accordance with our discretion regarding such matters, and consistent
25 with our Decision in the recent UNS Gas case, we reject the Company's proposal on this issue and
26 find that a rate of return of 7.03 percent on FVRB is reasonable and appropriate for UNSE, at this
27 time.

28 ...

AUTHORIZED INCREASE

Based on our findings herein, we determine that UNSE is entitled to a gross revenue increase of \$4,018,678.

Fair Value Rate Base	\$167,551,067
Adjusted Operating Income	9,334,283
Required Rate of Return	7.03%
Required Operating Income	11,792,753
Operating Income Deficiency	2,458,469
Gross Revenue Conversion Factor	<u>1.63463</u>
Gross Revenue Increase	\$4,018,678

RATE DESIGN**Minimum Customer Charge**

UNSE proposed an increase to the monthly residential customer charge from \$6.50 to \$7.70, and an increase in the customer charge for small general service customers from \$10.00 to \$12.00 per month. The Company contends that its proposal is supported by its cost of service study and that the minimum monthly charge increase is a "bare bones" approach in that the charge would recover only the Company's undisputed fixed customer service costs, for items such as metering, meter reading, billing and the service drop (Ex. A-18, at 2-6). RUCO does not oppose the Company's proposal (RUCO Ex. 10, at 18).

Staff witness Frank Radigan generally agreed that the Company's cost of service study supports an increase to the customer charge, and he recommended an increase that is only slightly less than that proposed by the Company (\$7.50) (Ex. S-61, at 1-2). He also agreed with the Company's other proposed customer charge increases of \$12.00 for small general service, \$15.50 for large general service, \$365 for large power service (less than 69 kV), and \$400 for large power service (69 kV and above).

There is no dispute that UNSE's cost of service study justifies increasing the current customer charges. However, we agree with Staff's witness that the residential customer charge should only be increased to \$7.50 per month, with the accompanying commodity charges based on Staff's rate design flowing from the revenue requirement established in this Order. Based on the revenue requirement established above, the "base rate" volumetric charge would be set for residential

1 customers at \$0.089248 per kWh for the first 400 kWh, and \$0.09926 per kWh for usage over 400
2 kWh, for customers in both Mohave and Santa Cruz Counties. The volumetric "base rates" reflect
3 the consolidation of rates for Mohave and Santa Cruz customers and the inverted block rate structure
4 (see discussion below). However, these volumetric rates do not include the additional PPFAC
5 charge, which is being set initially at \$0.014746 per kWh for all usage.

6 For a residential customer in Mohave County, with average monthly usage of 894 kWh, the
7 overall bill (including the PPFAC charge) would increase from \$89.82 to \$105.42, or approximately
8 17.4 percent. For a residential customer in Santa Cruz County, with average monthly usage of 719
9 kWh, the overall bill (including the PPFAC charge) would increase from \$76.65 to \$85.44, or
10 approximately 11.5 percent.

11 Mandatory Time-of-Use Rates

12 UNSE proposed implementation of mandatory time-of-use ("TOU") rates as a means of
13 reducing peak demand by shifting consumption to off-peak periods. According to Company witness
14 Erdwurm, shifting of demand would enable UNSE to reduce spot market energy purchases during
15 peak, resulting in savings for the Company and its customers (Ex. A-17, at 17).

16 Under the Company's proposal, all new residential, new small general service, and new and
17 existing large general service customers (Greater than 1,000 kW) would be placed on TOU rate plans.
18 During winter months (November through April), UNSE's TOU plan would impose higher rates
19 from 6 a.m. to 10 a.m., and again from 5 p.m. to 9 p.m. In the summer months (May through
20 October), peak rates would apply from 2 p.m. to 6 p.m., with "shoulder" rates from 12 p.m. to 2 p.m.
21 and 6 p.m. to 8 p.m., and off-peak rates the remainder of the day (*Id.* at 17-19).

22 UNSE contends that voluntary TOU rates have failed to produce the desired peak shifting
23 because relatively few customers currently participate. Although the Company concedes that TOU
24 meters are more costly than non-TOU meters, Mr. Erdwurm stated that the long-term benefits will
25 outweigh the short-term costs, especially as the cost of storing information declines and TOU meters
26 become less costly (Ex. A-18, at 12-13).

1 Mr. Magruder agrees with the Company's proposed mandatory TOU rates, but suggests
2 UNSE should pay the cost of new TOU meters for existing customers that switch to a TOU rate. For
3 new customers, he proposes that the customer be responsible for the cost of the TOU meter.

4 Although RUCO agrees with UNSE's TOU plan, Staff opposes making TOU rates mandatory
5 instead of continuing TOU as a voluntary option. Staff witness Frank Radigan stated that the annual
6 incremental cost of a new TOU meter would amount to approximately \$30 per customer, requiring a
7 residential customer to move 400 kWh of energy from peak to off-peak per month during the summer
8 to break even or achieve a benefit (Ex. S-61, at 9). He indicated that, because 30 percent of
9 customers use less than 400 kWh, and 92 percent of bills are for usage less than 2,000 kWh per
10 month, "it is very doubtful that the customers could move enough energy from the on-peak period to
11 the off-peak period to justify the meter expense" (*Id.*).

12 Mr. Radigan testified that some customers would realize a benefit from TOU rates. For
13 example, approximately 8 percent of residential customers have usage over 2,000 kWh per month,
14 but those customers account for more than 25 percent of the Company's sales to the residential class.
15 Because those customers would benefit from TOU rates, Mr. Radigan recommended a "vigorous
16 customer education" program to prompt such customers to move to TOU rates (*Id.*). He noted that
17 the same benefit would be realized for the small general service customers, for which 16 percent of
18 bills are in excess of 2,000 kWh, which accounts for 49 percent of all usage in that service
19 classification.

20 We understand UNSE's frustration with the lack of customer participation in the current
21 voluntary TOU program. However, we agree with Staff that the plan should not be made mandatory,
22 at this time, because the vast majority of residential customers would not benefit from participation.
23 We agree with Staff that the more equitable solution to increasing participation in the TOU plan is to
24 educate customers that may benefit from TOU rates through an aggressive educational campaign.
25 We therefore direct UNSE to file, within 60 days of the effective date of this Decision, a proposal for
26 increasing customer awareness of TOU rates and the benefits that may result from participation.

27 ...

28 ...

1 Inverted (Inclining) Block Rate Structure

2 UNSE proposed implementation of an inclining block rate structure as a means of
3 encouraging conservation. For residential and small general service customers, the Company's
4 proposal would apply a one cent per kWh discount for the first 400 kWh of usage, compared to the
5 second block for all usage over 400 kWh. RUCO agrees with the Company's inclining block rate
6 structure.

7 Mr. Magruder agrees with UNSE's inverted block proposal. He asserts that such a rate
8 structure may help reduce the Company's overall demand.

9 Although Staff agrees with the inclining block structure, in principle, Staff witness Radigan
10 stated that it should not be implemented, at this time, due to the relatively small rate increase
11 requested in this case, which could cause some customers to receive rate decreases, thereby leading to
12 increased consumption and customer confusion (Ex. S-61, at 13). Mr. Radigan acknowledged at the
13 rate case hearing that the customer confusion about which he is concerned may be alleviated through
14 the Company's customer education efforts. Mr. Radigan also testified that most of the rate increase
15 was captured within the increase in the customer charge and it was difficult to design rates with a one
16 cent declining block rate without decreasing rates for some customers (Tr. 1268-69).

17 We agree with the parties that an inverted block rate structure sends a strong and important
18 price signal to customers to conserve energy. While we recognize Staff's concern that some
19 customers will receive a rate decrease while other customers receive a rate increase, the public policy
20 behind incenting conservation outweighs the concerns raised by Staff. We will approve UNSE's
21 inverted block rate design as supported by all parties but Staff.

22 Consolidation of Rates for Mohave and Santa Cruz

23 UNSE's customers in Mohave and Santa Cruz counties currently have separate rate structures.
24 Although minimum monthly charges are the same in both areas, Mohave customers' kWh rates for
25 residential and small general service customers are lower than in Santa Cruz. The Company proposes
26 to consolidate these rates into a single rate structure that would result in a larger percentage increase
27 for Mohave customers compared to Santa Cruz (Ex. A-17, at 20). UNSE claims that due to the
28 relatively small increase being requested in this proceeding, the rate consolidation is appropriate. Mr.

1 Erdworm states that the Santa Cruz customers have been paying too much relative to Mohave
2 customers, and this case presents an opportunity to remedy the inequity (Ex. A-18, at 15). RUCO
3 agrees with the Company's proposal to consolidate the Mohave and Santa Cruz rates. Staff witness
4 Radigan opposes UNSE's request and recommends, instead, that consolidation of rates be
5 accomplished over two rate cases. Mr. Radigan claims that, under current rates, the absolute dollar
6 differential between customer bills is minor, and consolidating the rates at this time would send the
7 wrong price signal to Santa Cruz customers, who would experience a rate decrease at the same time
8 the Company's costs are increasing (Ex. S-61, at 14-15). He proposes that, in this case, the customer
9 charge be increased for both Mohave and Santa Cruz from the current \$6.50 to \$7.50 per month, but
10 that Santa Cruz customers receive a lower commodity charge increase to move rates in the two areas
11 closer. Mr. Radigan suggested that, in the Company's next case, the commodity rates would be fully
12 merged into a single rate (*Id.*).

13 Mr. Magruder proposes that residential and small business rates in both the Mohave and Santa
14 Cruz areas should be combined into a single rate. Mr. Magruder claims that there is no valid basis for
15 continuing separate rates and states that customers in Santa Cruz County have been paying higher
16 rates than those customers in Mohave County for many years.

17 We find the Company's proposal to consolidate the Mohave and Santa Cruz rates is
18 reasonable and should be approved. Mr. Radigan's arguments on this subject are unconvincing. The
19 evidence that UNSE is running the two operations as one system is undisputed. Given that the
20 Company's operations are combined, it is inequitable for Santa Cruz customers to have a higher rate
21 than Mohave customers. This inequity should be corrected now and not put off until some future rate
22 case.

23 Demand Charge Differential

24 UNSE proposed a reduction to the differential between the demand charge for service taken at
25 less than 69 kV (\$24.75) and service taken at 69kV (\$16.10). The Company believes the differential
26 (\$8.65), which should represent the cost for transformation service to reduce voltage below 69 kV, is
27 too high and imposes a significant cost on low load factor customers taking service at lower voltage
28

1 (Ex. A-18, at 15). Company witness Erdwurm testified that, based on his experience, the differential
2 was too large absent any uniqueness of the service provider (Tr. 468).

3 Staff witness Radigan stated that UNSE's cost of service study does not provide a breakdown
4 of costs for providing service at or below 69 kV and, absent supporting documentation, the
5 Company's request should be denied (Ex. S-61, at 17). Although Mr. Erdwurm amended the
6 Company's request in his rebuttal testimony (to narrow the differential from the current \$8.65 to
7 \$7.00), Mr. Radigan testified that there is no basis to support the Company's proposal. He indicated
8 that the UNSE system transforms power down to a variety of different voltages and, without a study,
9 it is impossible to determine at which of the lower voltages the majority of large commercial
10 customers are taking power (Ex. S-62, at 4).

11 We agree with Staff that, absent a study showing the costs of serving respective large
12 commercial customers at various voltages, it is difficult to modify a demand rate to accurately reflect
13 the costs of serving such customers. As Mr. Radigan points out, a large commercial customer could
14 take service from a 13.8 kV line and such a customer should be required to pay for both the
15 transformation of power and the distribution of power over miles of distribution lines (*Id.* at 4-5).
16 Without an accurate cost of service study, it is virtually impossible to determine how much
17 equipment on the other side of the step down transformer is being utilized by large commercial
18 customers. For these reasons, we adopt Staff's recommendation on this issue.

19 CARES Discount

20 UNSE proposed year-round flat discounts of \$8.00 per month for CARES customers and
21 \$10.00 per month for CARES-Medical customers. Under the current CARES program, a declining
22 percentage discount is applied to customer bills as usage increases, with a flat discount of \$8.00
23 applied to customers with usage over a 1,000 kWh threshold and over a 2,000 kWh threshold for
24 CARES-Medical customers. The Company argues that the current program discourages conservation
25 because the flat discount does not apply until customers reach a minimum usage threshold (Ex. A-18,
26 at 15-16). RUCO supports UNSE's proposal to implement the flat discounts (RUCO Ex. 10, at 18).

27 Staff contends that the current program should remain intact. Staff witness Julie McNeely-
28 Kirwan testified that, under the current CARES program, customers using the least amount of energy

1 receive the highest percentage discount (30 percent) on their entire bills, while customers using
2 progressively higher amounts of energy receive lower percentage discounts (*i.e.*, 20 percent, 10
3 percent, or flat \$8.00 discount once usage exceeds 1,000 kWh, or 2,000 kWh for CARES-Medical).
4 Ms. McNeely-Kirwan points out that the current rate structure provides a built-in incentive to
5 conserve, in order to receive the highest possible discount (Ex. S-66, at 2). She also notes that the
6 \$8.00 discount that is achieved, once a threshold is reached, amounts to less than a 1 percent discount
7 (*Id.*).

8 We agree with Staff that the current CARES rate structure should be continued. Contrary to
9 the Company's claims, the current structure promotes conservation by offering a 30 percent discount
10 to the total customer bill for the lowest usage. As usage increases, CARES customers receive
11 progressively lower discounts on their bills, thereby providing customers with a price signal that
12 encourages such customers to limit their energy use.

13 We also agree with Staff that UNSE should clarify the language on its website to more clearly
14 describe the CARES discounts that are available, especially to inform customers that the discount is
15 applicable to the entire customer bill, based on total monthly usage (*i.e.*, usage of 300, 600 or 1,000
16 kWh for CARES and 600, 1,200 or 2,000 kWh for CARES-Medical would trigger progressively
17 smaller discounts). In addition, UNSE should be required to separately report Cares-Medical
18 participation in its CARES report, in accordance with Staff's recommendation (Ex. S-67, at 3-4).
19 The Company should modify the language on its website, in a form acceptable to Staff, within 60
20 days of the effective date of this Decision.

21 Low-Income Customer Issues

22 In its brief, UNSE states that it is committed to making several improvements to service
23 provided to low-income customers. The Company indicated that it has proposed the addition of a
24 Warm Spirits program, similar to that offered by UNS Gas, that would be a voluntary customer-
25 funded program that provides emergency bill payment assistance to low-income customers. The
26 Company stated that it would match customer donations, dollar-for-dollar, up to \$25,000 per year,
27 and would also move \$20,000 for Emergency Bill Assistance from the Low-Income Weatherization
28 ("LIW") program into Warm Spirits. An additional commitment made by UNSE is to increase LIW

1 funding from \$70,000 to \$105,000 annually, and increase the maximum per house expenditure from
2 \$1,600 to \$2,000. Finally, UNSE indicated that it plans to offer its customers a more convenient way
3 to pay their bills in cash, as an alternative to payday loan businesses (Tr. 517) (UNSE Initial Brief, at
4 62).

5 Mr. Magruder recommended that the Company be required to cease using payday loan
6 companies within 60 days of this Decision unless the Company meets certain requirements
7 recommended by the Consumer Law Center.

8 On February 22, 2008, UNS Gas filed (in Docket No. G-04204A-06-0463 et al.) "Notice of
9 Filing of Payment Alternatives in Compliance with Decision No. 70011." In its filing, UNS Gas
10 stated that it has developed an alternative to requiring cash payments to be made at payday loan
11 stores. According to UNS Gas, it is in the process of developing a cash payment option called
12 PayScan™ that would enable customers to make cash payments at all Circle K stores in Arizona for a
13 service fee of \$1.50. UNS Gas expects the new program to be implemented by the second quarter of
14 2008 and, upon implementation, will notify customers of the option by bill inserts, website updates,
15 and signs posted at cash payment sites.

16 We believe UNSE's low-income customer commitments are reasonable and should be
17 approved. With respect to the Warm Spirits program, in addition to other educational materials it
18 provides customers, the Company should also, within 60 days of the effective date of this Decision,
19 place a section on customer bill payment stubs that allows customers to check a box to indicate they
20 would like to make a contribution at the time they write their payment checks. This requirement is
21 consistent with the practice followed by APS, Southwest Gas and UNS Gas for similar programs.
22 Regarding the PayScan™ program, we direct the Company to file in this docket, within 60 days of
23 the effective date of this Decision, an updated report regarding implementation of the program for
24 UNSE.

25 ...

26 ...

27 ...

28 ...

1 Demand-Side Management Adjustor Mechanism

2 In this case, UNSE seeks approval of a Demand-Side Management ("DSM") adjustor
3 mechanism to recover a portion of the costs of its DSM programs¹⁵. The Company agreed with Staff
4 witness Jerry Anderson's recommendation (Ex. S-63, at 15-16) to fund 100 percent of its expanded
5 LIW program costs, and 25 percent of the other DSM program costs, through the adjustor mechanism
6 (Ex. A-6, at 6). UNSE claims that the initial adjustor charge is expected to support this level of
7 funding, and the adjustor mechanism would be reset annually to ensure the proper level of funding
8 (Ex. S-63, at 13-17). UNSE, Staff and RUCO are in agreement regarding the Company's DSM
9 adjustor mechanism proposal.

10 Mr. Magruder made observations and recommendations regarding the Company's individual
11 DSM programs. He also proposed that the DSM, Renewable Energy Standard ("RES") and PPFAC
12 adjustors should be reset collectively on the same date each year.

13 We believe the DSM Docket is the appropriate place to address the details of the Company's
14 specific DSM programs. Mr. Magruder's concerns regarding those programs can be taken into
15 consideration by Staff during its analysis in that docket. The adjustor approved herein will be set
16 initially at \$0.000583 per kWh and adjusted annually on June 1 of each year, beginning on June 1,
17 2009, in accordance with Staff's recommendation.

18 EPS/REST Adjustor Mechanism

19 According to Staff witness Jerry Anderson, UNSE is currently required to meet the
20 Environmental Portfolio Standards ("EPS") set forth in A.A.C. R14-2-1618. However, the
21 Commission subsequently adopted in Decision No. 69127 (November 14, 2006), Renewable Energy
22 Standard and Tariff ("REST") rules that are intended to replace the EPS rules (Ex. S-63, at 17-18).

23 UNSE currently recovers its renewable costs through an EPS surcharge that was approved on
24 an interim basis for Citizens Utilities Company in Decision No. 63360 (February 8, 2001). In this
25 proceeding, Staff recommended that the EPS surcharge be converted to an adjustor mechanism, in
26

27 ¹⁵ UNSE originally filed in this docket a request for approval of new and enhanced DSM programs but subsequently filed
28 an application in Docket No. E-04204A-07-0365 ("DSM Docket") for approval of its comprehensive DSM portfolio. The
DSM Docket application is pending before the Commission.

1 accordance with the REST rules requirements, with the same EPS rate currently in effect (Ex. S-63,
2 at 19).

3 On October 12, 2007, UNSE filed an application for approval of its proposed RES
4 Implementation Plan and Associated Tariff (Docket No. E-04204-07-0593). That application
5 requested, among other things, that the Company be released from all obligations under the EPS rules
6 (A.A.C. R14-2-1618), that the remaining EPS funds could be used for REST program expenses, and
7 an effective date and reset date for the REST adjustor charge (UNSE Reply Brief, at 34).

8 At its April 9, 2008, Open Meeting, the Commission addressed UNSE's REST Plan and
9 adopted Staff's recommendations regarding the Company's application (Docket No. E-04204-07-
10 0593). In the Order discussed at the April 9, 2008, Open Meeting, the Commission, among other
11 things: stated the REST rules superseded the EPS rules; released UNSE from the EPS rule
12 requirements, and directed that any remaining EPS funds be applied to the REST program; directed
13 that UNSE no longer charge the EPS surcharge and no longer file the annual EPS surcharge report;
14 established REST tariff rates¹⁶; and deferred establishment of the REST adjustor mechanism to this
15 rate case.

16 We agree with Staff's recommendation to approve a REST adjustor mechanism in accordance
17 with the REST rules. Consistent with the Commission's discussion at the April 9, 2008, Open
18 Meeting, the new REST adjustor would replace the EPS surcharge and any remaining EPS funds
19 would be applied to the REST program. As described by Mr. Anderson, the Company would be
20 entitled to file an application to change the adjustor rate and caps, subject to Staff review and
21 Commission approval or modification. The adjustor charge will continue to be listed on customer
22 bills as a separate line item.

23 Outages for Customers on Life Support Equipment

24 Mr. Magruder proposed that UNSE be required to identify all customers that have life support
25 equipment, its type and battery capabilities, and provide that information to local law enforcement
26

27 ¹⁶ The approved REST rates are as follows: \$0.004988 per kWh, with a monthly cap of \$2.00, for residential customers;
28 \$39.00 for non-residential customers; and \$500.00 for non-residential customers with demands of 3 MW or greater
(Recommended Order, at page 9, in Docket No. E-04204-07-0593, approved at April 9, 2008, Open Meeting).

1 offices so that public safety agencies would be able to check on such customers during power
2 outages.

3 UNSE responded that it is opposed to sharing customer information with third parties but,
4 even if it could share such information, the Company is not able to reliably track where specific
5 customers are located on its system (Ex. A-22, at 6). UNSE claims that it uses outage status
6 recordings to inform customers, but the Company has no way of knowing whether every specific
7 customer has a sufficient backup supply for a certain period of outage. However, UNSE witness
8 James Pignatelli stated that the Company is willing to work with safety response agencies regarding
9 this issue (Tr. 71-72).

10 Although we do not believe Mr. Magruder's suggested remedies are necessarily the best way
11 to address the issue he raises, given Mr. Pignatelli's commitment to work with appropriate agencies,
12 we direct the Company to file within 90 days of the effective date of this Decision a statement
13 regarding suggested changes to its procedures that may address the concerns raised by Mr. Magruder
14 on this issue.

15 Nogales/Citizens 1999 Settlement Agreement

16 Mr. Magruder claims that UNSE, as the successor to Citizens Utilities, has failed to comply
17 with certain provisions of a Settlement Agreement between the City of Nogales and Citizens that was
18 approved by the Commission in Decision No. 61793 (June 29, 1999). The items cited by Mr.
19 Magruder include the alleged failure by UNSE to fund interest-free college loans for students in
20 Santa Cruz County, the assertion that UNSE failed to undertake 20 above-ground pole replacements
21 and 12 underground cable projects, and the need for re-establishment of a Citizens Advisory Council
22 in Santa Cruz County.

23 During the hearing, the Administrative Law Judge directed UNSE to contact Mr. Magruder to
24 discuss his concerns regarding these matters. In its reply brief, the Company claims that a Company
25 representative met with Mr. Magruder on October 16, 2007, and, although UNSE believes it has
26 complied with the terms of the prior settlement agreement, the company will continue to work with
27 Mr. Magruder to address his concerns (UNSE Reply Brief, at 35-36).

28 ...

1 Magruder Proposed Rate Base Adjustment

2 Intervenor Marshall Magruder recommended that the Commission disallow from UNSE's rate
3 base \$15,561,520 due to the Company's alleged failure to comply with prior Commission Orders
4 related to improvements to the UNSE system in Santa Cruz County. Mr. Magruder claims that
5 UNSE's predecessor, Citizens Utilities, submitted a Plan of Action ("POA") in 1999 to make
6 improvements to its system in Santa Cruz County due to quality of service concerns. According to
7 Mr. Magruder, a Settlement Agreement between Staff and Citizens was approved by Decision No.
8 62011 (November 2, 1999), which Agreement required Citizens to undertake 20 utility pole
9 replacement projects and 12 underground cable replacement projects in Santa Cruz County. Mr.
10 Magruder contends that the Citizens POA included annual budgets of \$15,561,520 for these projects.
11 He stated that some of the projects were over budget by early 1999, some were never started, and
12 others are unknown (Ex. M-23, at 30-31). Mr. Magruder also seeks to reduce the Company's rate
13 base by \$282,440 based on his claim that pole and underground cable replacements in that amount
14 were completed by Citizens prior to the UNSE acquisition in 2003 (*Id.* at 34). Mr. Magruder
15 therefore requests that UNSE's rate base be reduced by these amounts.

16 The Company claims that Mr. Magruder provided no supporting evidence justifying his
17 proposed disallowances, and the Settlement Agreement between Nogales and Citizens contains no
18 provision regarding pole replacements. UNSE argues that it had the discretion to determine which, if
19 any, pole replacements were needed based on existing circumstances. The Company contends that it
20 has researched and engineered needed pole replacements, and has completed any needed
21 replacements. UNSE asserts that it is providing reliable service, a point with which Staff agrees (Ex.
22 S-55, at 6-7).

23 It is unclear from the record whether there are uncompleted requirements related to the
24 Citizens POA, as Mr. Magruder claims. However, we do not necessarily agree that the remedy
25 proposed by Mr. Magruder is appropriate, and we believe additional information is needed before any
26 further action is taken. We will therefore direct UNSE to file a detailed response to Mr. Magruder's
27 allegations on this issue, within 60 days of the effective date of this Decision. Replies to the
28 Company's response shall be filed by Mr. Magruder, Staff, and RUCO within 30 days thereafter.

1 Student Loans and Scholarships

2 With respect to the interest-free student loans, UNSE states in its reply brief that, consistent
3 with Mr. Pignatelli's testimony at the hearing (Tr. 55), the Company awarded 7 scholarships to
4 Nogales High School students from 1999 to 2003 through the Nogales Educational Foundation, and
5 will provide additional scholarships if required by the settlement agreement. The Company added
6 that it has also committed to fund additional scholarships over the next four years for students at
7 Nogales High School and Rio Rico High School (UNSE Reply Brief, at 35).

8 On December 27, 2007, Mr. Magruder filed a document entitled Notice and Filing of Late-
9 Filed Exhibits¹⁷. Mr. Magruder claims that his filing "summarizes information from the new
10 information that came to light" in UNSE's reply brief, regarding student scholarships, a Citizens
11 Advisory Council, and the pole and cable replacement projects (Magruder December 27, 2007 Filing,
12 at 3). Mr. Magruder essentially restates his prior arguments from the hearing, claiming that UNSE
13 has not complied with the requirements of the Nogales/Citizens Settlement Agreement regarding
14 these issues. Mr. Magruder contends that all of the scholarships cited by Mr. Pignatelli were awarded
15 before UNSE acquired Citizens, and that the Settlement Agreement requires the Company to fund
16 \$3,000 annually of interest-free loans for students attending Arizona colleges, if the students
17 receiving the loans agree to return to Santa Cruz County for two years following graduation. Mr.
18 Magruder argues that the Company's commitment to two scholarships per year, rather than the
19 annual loan requirement, "is as ungenerous to complying with the 'annual' requirement as UNSE
20 could make to this third-world County" [i.e., Santa Cruz County] (Magruder Reply, at 1, emphasis
21 original). Mr. Magruder also reiterates his claim that UNSE deliberately failed to replace known
22 defective underground cables and utility poles, and that the Citizens Advisory Council, although
23 required by the Settlement Agreement, has not met in over 7 years.

24 It is not entirely clear from the evidentiary record, or the extra-record, late-filed exhibits
25 submitted by Mr. Magruder, whether UNSE is in compliance with its obligations under the prior
26 Settlement Agreement between the City of Nogales and Citizens. Mr. Magruder contends that UNSE

27 _____
28 ¹⁷ UNSE filed a Response on January 9, 2008, and Mr. Magruder filed a Reply to the Company's Response on January 15, 2008.

1 is deficient regarding several matters, while the Company maintains that it has complied fully with its
2 responsibilities. No other party has alleged that UNSE is not in compliance with the Commission
3 Order cited by Mr. Magruder. Given that some of the information upon which Mr. Magruder relies
4 was not available at the time of the hearing, we believe the most efficient means of addressing his
5 concerns is to direct UNSE to meet with Mr. Magruder and, if necessary, request that Staff be
6 included in the discussions to provide an objective perspective regarding these issues. Therefore,
7 UNSE should initiate a meeting with Mr. Magruder within 30 days of the effective date of this
8 Decision, and file within 90 days of the effective date of this Decision a statement regarding
9 suggested resolution of the concerns raised by Mr. Magruder on this issue.

10 Proposed Changes to Rules and Regulations

11 UNSE proposed several changes to its existing Rules and Regulations governing service.
12 Among those proposed changes is a reduction in the free footage allowed for line extensions, a
13 service connection contribution fee for new service meters, and a proposal to reduce the period, from
14 15 days to 10 days, that customers have to pay their bills before the bills are considered past due.

15 Line Extension Policies and Service Connection Contribution

16 UNSE currently provides an overhead line, or underground service line in areas served by
17 underground lines, up to 150 feet with no more than one carryover pole for each residential customer,
18 without charge (Ex. A-54). The Company proposed elimination of 50 feet of that amount, and one
19 carryover pole, from its overhead line connection (Ex. A-55). Because UNSE's current line
20 extension policy also allows for 400 feet of free footage (Ex. A-56), the total free footage allowance
21 would drop from 550 feet, and one carryover pole, to 500 feet and no carryover pole (Ex. A-21, at 9).

22 Staff proposes that the free footage allowance be eliminated entirely to increase the likelihood
23 of growth paying for growth (Ex. S-64, at 4-5). Staff witness Bing Young stated that eliminating free
24 footage would lessen the financial strain on UNSE to extend service to new customers in a growing
25 service area. Mr. Young testified that adoption of Staff's recommendation "would significantly
26 improve [UNSE's] ability to recover its distribution costs associated with this growth" (*Id.*). The
27 Company opposes Staff's recommendation on the basis that such a change would have an adverse
28 impact on development in Mohave and Santa Cruz counties (Ex. A-21, at 9-10).

1 In response to questions from Commissioner Mayes, UNSE proposed at the hearing a Service
2 Connection Contribution ("SCC") fee of \$250 that would be required of each new customer¹⁸. The
3 \$250 fee would be treated as a non-refundable contribution to offset construction costs for new
4 service line connections (Ex. A-46). Company witness Grant testified at the hearing that the
5 proposed fee would be similar to a "hook-up fee" except the SCC would not strictly offset
6 construction costs for off-site backbone facilities (Tr. 1064-66). Mr. Grant testified that the SCC
7 would bring in as much as \$1.5 million annually, assuming 6,000 new connections per year, but the
8 Company prefers not to implement this proposal until after the pending generic hook-up fee docket
9 has been concluded (Docket Nos. E-00000K-07-0052 and G-00000E-07-0052) (Tr. 960-61). Staff
10 opposes implementation of the SCC in this proceeding and recommends that the issue of hook-up
11 fees be addressed in the generic docket.

12 We agree with Staff's recommendation to eliminate the free footage allowance currently in
13 effect for UNSE. As noted above, UNSE has advocated the need for CWIP and other rate relief
14 mechanisms to mitigate the financial pressures associated with extending service to new customers in
15 a growing service area. The elimination of free footage will help mitigate UNSE's required capital
16 costs in dealing with customer growth and will also help ensure that the costs of serving growth are
17 paid for by the customers that cause those costs. We also agree with Staff that UNSE's proposed
18 SCC should not be adopted in this proceeding. The issue of hook-up fees for UNSE would, at least at
19 this time, be better addressed in the generic docket where all relevant factors can be considered,
20 including the income tax implications for companies that implement hook-up fees.

21 Bill Payment Due Date

22 As set forth in A.A.C. R14-2-210(C), "all bills for utility services are due and payable no later
23 than 15 days from the date of the bill," and "[a]ny payment not received within this time-frame shall
24 be considered delinquent and could incur a late payment charge."

25 UNSE proposes to modify its billing terms in its tariffs by reducing from 15 days to 10 days
26 (from the time the bill is rendered) the time for customers to pay bills before the bills are considered

27 _____
28 ¹⁸ The SCC would be waived for customers that build a home in compliance with the Company's "Energy Smart Homes"
efficiency standards (Tr. 1066).

1 “past due.” The Company’s proposed change would make its billing practices consistent with the
2 tariffs approved for UNS Gas in Decision No. 70011¹⁹. UNSE witness Thomas Ferry contends that
3 even under the proposed billing change, customers would have plenty of time to pay bills before late
4 payment charges would apply or termination of service would be implemented (Ex. A-21 at 2).
5 According to Mr. Ferry, after the 10-day payment period, customers would have an additional 15
6 days before a reminder notice would be sent, for a total of 26 days. At that point, the bill would be
7 considered delinquent, and late charges would apply, but termination-of-service procedures (*i.e.*,
8 notice of termination) would not commence for an additional 5 days (*Id.*). Mr. Ferry also indicated
9 that the Company would continue its current practice of working with customers that request or are in
10 need of payment extensions (*Id.*).

11 Although RUCO witness Diaz Cortez initially opposed the Company’s proposed changes to
12 billing dates, based on her apparent understanding that bills would be considered delinquent in a
13 shorter period of time than currently exists, but RUCO did not address this issue in its brief so it is
14 not clear if RUCO was persuaded by the explanation in Mr. Ferry’s rebuttal testimony. Staff argues
15 on brief that UNSE’s proposal does not comply with the Commission’s rules, based on its reading of
16 the rule stating that bills shall not be considered “past due” for at least 15 days after the bill is
17 rendered.

18 We agree with UNSE that the proposed billing changes are reasonable. We believe the billing
19 changes are consistent with the Commission’s Rules, which require only that payments not be
20 considered “delinquent” (and therefore subject to late charges) sooner than 15 days after the bill is
21 rendered. As explained above, the Company’s proposal would not consider payments delinquent
22 until at least 25 days after issuance, and the termination timeline would remain unchanged. As we
23 indicated in Decision No. 70011 (at page 74), the proposed change would allow the customer call
24 center representatives to have a single set of rules in place for all of the UniSource affiliates, which
25 should minimize potential errors that may occur when information regarding delinquent bills and/or
26

27 ¹⁹ The rule for gas companies (A.A.C. R14-2-310(C)) provides that payments not received within 10 days are considered
28 “past due” while the rule for electric companies (A.A.C. R14-2-210(C)) states that payments received more than 15 days
after the bill is issued are considered “delinquent.” It is unclear whether this difference in terminology is intentional or
due to an oversight.

1 termination of service is provided to customers. In addition, as the UNSE witness pointed out, a bill
2 would not be subject to a late payment charge until at least 25 days after the bill is rendered, and a
3 termination of service notice for nonpayment could not occur sooner than 30 days following issuance
4 of a bill. We believe that these timeframes provide an adequate period for customers to either pay a
5 bill or seek alternative payment arrangements prior to being subjected to a penalty or termination of
6 service. We therefore approve the Company's proposed changes to its billing tariffs. However, in
7 accordance with the UNS Gas Order, we direct UNSE not to implement the approved billing change
8 for a period of six months following the effective date of this Decision in order to allow a transition
9 for customers to the revised billing rule.

10 Bill Estimation

11 As described in the testimony of Staff witness Bing Young, UNSE's tariffs do not provide an
12 explanation of its bill estimation methodology. Mr. Young recommended that the Company be
13 required to submit a separate tariff setting forth its estimation methods, within 30 days of the
14 effective date of this Decision (Ex. S-64, at 7-9). Mr. Young also listed the specific parameters that
15 should be included in the Company's bill estimation tariff (*Id.*).

16 UNSE witness Ferry stated that he is not aware of any customer confusion regarding bill
17 estimation, but indicated that the Company is open to reviewing its policies when TOU billing is
18 offered to a larger customer base.

19 Given our rejection of UNSE's mandatory TOU proposal, it is not clear whether the
20 Company's conditional concession on this issue means that it does not oppose Staff's
21 recommendation. In any event, we agree with Staff that UNSE should provide more detail in its
22 tariffs regarding the methodology it employs for bill estimations. The greater level of detail will
23 allow more transparency for customers, as well as Commission Staff in fielding calls from customers
24 regarding the issue. UNSE should therefore submit a revised bill estimation tariff, for Commission
25 approval, in accordance with the criteria set forth in Mr. Young's testimony, within 30 days of the
26 effective date of this Decision.

27 ...

28 ...

1 Magruder Suggestions Regarding UNSE Tariffs

2 Mr. Magruder proposed that UNSE should be directed to: rewrite its rules and regulations in
3 plain English and Spanish in order to improve customer understanding; provide key portions of the
4 rules and regulations to all customers; facilitate understanding of billing collection schedules and
5 collection, deposits, service termination and complaint handling; absorb credit and debit card fees as
6 a business expense; and reformat its billing statements to improve customer understanding.

7 UNSE responded that its proposed rules are in full compliance with all Commission rules and
8 regulations, and much of the language in its tariffs comes directly from, and is organized in a manner
9 similar to, the Commission's rules. The Company claims that it already provides a copy of the
10 applicable rules for customers requiring line extensions, and that being required to provide copies of
11 rules to customers would be burdensome and unnecessary, given the fact that they are available
12 online. However, UNSE states that it does not object to translating its tariffs into Spanish and
13 making that version available online.

14 We find no basis for requiring the Company to undertake the efforts proposed by Mr.
15 Magruder. As UNSE points out, its tariffs, and the proposed changes to those tariffs, comply with the
16 Commission's rules and regulations and, in most instances, are identical or similar to the
17 Commission's rules. The Company has agreed to translate its tariffs into Spanish and post that
18 version online, which should address one of Mr. Magruder's biggest concerns.

19 OTHER ISSUES

20 Purchased Power and Fuel Adjustment Clause ("PPFAC")

21 UNSE currently obtains all of its power supply through a fixed price, full requirements
22 agreement with Pinnacle West. The Pinnacle West contract expires May 31, 2008, and the Company
23 must obtain a new supply of power prior to that date. UNSE witness Michael DeConcini testified
24 that the current fixed price contract will be replaced by new sources of power that include short-term
25 wholesale purchases. As a result, the Company contends that a modified PPFAC is needed that will
26 enable UNSE to recover its actual costs of purchased power and fuel (Ex. A-14, at 19).

27 UNSE initially proposed a cost recovery mechanism that would automatically adjust based on
28 a 12-month rolling average cost for fuel and purchased power. However, Staff recommended a

1 PPFAC that is comparable to the Power Supply Adjustor ("PSA") approved for APS in Decision No.
2 69663 (June 28, 2007), adjusted for UNSE's specific circumstances (Ex. S-56, at 80-85). In his
3 rebuttal testimony, Mr. DeConcini agreed to Staff's proposed PPFAC mechanism, along with a
4 proposed Plan of Administration ("POA") to operate the PPFAC (Ex. A-15, at 8, 16).

5 The PPFAC agreed upon by UNSE and Staff provides for an effective date of June 1, 2008,
6 when the Company's new power supply agreements will take effect. Prior to that date, the base cost
7 of fuel and purchased power would be set at a level that reflects costs under the current contract and,
8 therefore, the PPFAC rate would be set at zero (until June 1, 2008) (Ex. A-17, at 21; Ex. A-15, at 8-
9 9). Under the terms of the POA, the PPFAC would have a "forward component" and a "true-up
10 component." The forward component would be based on forecasted fuel and purchased power costs,
11 and the true-up component would compare actual fuel and purchased power costs with the amounts
12 collected through base rates and the PPFAC rate in the prior year (Ex. A-15, at 9-12). The POA also
13 provides that the true-up component would reconcile actual and forecast fuel and purchased power
14 costs, and the true-up would be incorporated into the following year's PPFAC rate (*Id.*). In addition,
15 under the POA agreed upon by UNSE and Staff, the PPFAC would run from June 1 through May 31
16 of the following year; the Company would be required to file by December 31 information and
17 calculations showing the following year's forward and true-up components; Staff would have until
18 February 15 to issue initial comments, or recommended adjustments, regarding the Company's
19 December 31 filing; and the Company would be required to file updated information and calculations
20 regarding the true-up component by April 1, with a Staff response to the updated information
21 required by April 15 (*Id.*). The POA does not contemplate that the Commission would approve each
22 new year's PPFAC, but the Commission could suspend the PPFAC or take other action prior to June
23 1. The POA further provides that, if an extraordinary event occurs that dramatically affects fuel and
24 energy prices, UNSE would be permitted to seek a modification of the forward component to mitigate
25 the chance that the subsequent true-up would result in an excessive increase (*Id.* at 12-14).

26 RUCO opposes the PPFAC advocated by the Company and Staff, and has proposed its own
27 adjustor mechanism. RUCO's recommendation is described below.

28

1 Although the Company and Staff are in general agreement regarding the PPFAC and POA,
2 the following two operational issues remain in dispute: "other allowable costs" recoverable under the
3 PPFAC and a "cap" on the PPFAC to mitigate the potential for rate shock due to wide swings in the
4 price of natural gas.

5 "Other" Allowable Costs in PPFAC

6 UNSE seeks the ability to include "other" costs (e.g., broker's fees, credit costs, and legal
7 fees) through the PPFAC because such costs are not currently recovered through the Company's base
8 rates due to its current full requirements contract (Ex. A-15, at 15; Tr. 339-42). UNSE claims that it
9 has not previously incurred procurement scheduling and management costs related to power
10 acquisition because of the long-standing contract with Pinnacle West. As a result, the Company
11 claims that such costs are not included in its current base rates and, without recovery through the
12 PPFAC, it would not have an opportunity to recover the "other" costs.

13 UNSE witness DeConcini stated that these costs are directly related to fuel and purchased
14 power procurement, the costs are likely to vary from year to year and, as such, are especially
15 appropriate for inclusion in the PPFAC (Ex. A-16, at 3-4). As an alternative, Mr. DeConcini
16 proposed that the Commission approve forecasted procurement, scheduling and management fees
17 allocated to UNSE from TEP's Wholesale Energy Group (*Id.*).

18 Staff opposes inclusion of an open-ended category of "other" costs in the PPFAC. Staff
19 argues that such costs should be recovered through base rates, just as other operating expenses are
20 treated (ex. S-58, at 54-56). Staff claims that no other utilities in Arizona have been permitted to
21 recover these types of costs through a PPFAC, and that a recent request by APS to include broker's
22 fees in its PSA was specifically rejected by the Commission in Decision No. 69663 (June 28, 2007, at
23 107-8). Staff witness Ralph Smith testified that UNSE's PPFAC should be limited to expenses
24 recorded in FERC Accounts 501, 547, 555 and 565, and that Section 9-B of the POA, labeled "Other
25 Allowable Costs," should contain the statement "None without pre-approval from the Commission in
26 an Order" (*Id.* at 56-57).

27 We agree with Staff that UNSE's request for recovery of "other" expenses through the
28 PPFAC should be denied. We believe Staff properly recommended that only fuel and purchased

1 power costs recorded in FERC Accounts 501, 547, 555 and 565 should be flowed through the
2 PPFAC, and no other costs should be included in the PPFAC unless the costs are approved by a
3 Commission Order. No other utility company has been permitted to recover such expenses through
4 an automatic adjustor mechanism and we see no valid basis to depart from that precedent. If "other"
5 costs become a significant burden on the Company's operations, it may seek recovery through base
6 rates, where all of its expenses and revenues are considered. We believe that the PPFAC mechanism
7 and accompanying POA proposed by Staff provide UNSE an opportunity to timely recover its fuel
8 and purchased power expenses, without the added guarantee that all "other" related expenses would
9 be automatically recovered through an adjustor outside of a base rate case.

10 PPFAC "Cap"

11 In his pre-filed testimony, Staff witness Smith did not support imposing a "cap" on UNSE's
12 PPFAC, agreeing with the Company that (1) because UNSE is in the process of acquiring and
13 developing its resource requirements, it would not be appropriate to cap the PPFAC rate in this period
14 of flux; (2) an inappropriately narrow cap could encourage short-term rate stability at the expense of
15 serving the long-term interests of customers; and (3) short-term rate stability through imposition of
16 caps that are too narrow could lead to large deferrals that negatively impact both the Company and
17 customers (Ex. S-58, at 54).

18 Near the end of the evidentiary hearing, Staff recalled Mr. Smith to testify regarding Staff
19 Exhibit 68, a proposal filed by Staff to impose an annual cap on the PPFAC rate in order "to address
20 the potential of PPFAC rate shock given new information presented by UNSE" (Ex. S-68). Mr.
21 Smith testified that Staff supports imposition of a "cap" on the forward component of the PPFAC, but
22 no cap on the true-up component (Tr. 1398-1401). Staff contends that its new PPFAC cap
23 recommendation was the result of Staff's analysis of documents (Exs. A-43 and A-44) that were
24 received from the Company at a relatively late stage in the hearing, after Staff's surrebuttal testimony
25 was filed. Staff argues that, upon review of the largely confidential documents received from UNSE,
26 Staff felt the need to inform the Commission of the real potential of PPFAC rate shock in the event of
27 sudden large increases in natural gas prices, and to offer a recommendation for addressing such a
28 situation.

1 UNSE argues that Staff's PPFAC cap recommendation could impose a substantial hardship on
2 the Company. Company witness Grant estimated that, if gas prices reach \$9.00 MMBtu, the annual
3 PPFAC deferral would be approximately \$23 million, an amount that would have to be financed by
4 UNSE. Mr. Grant stated that it is uncertain whether the Company's existing credit facility is
5 sufficient to finance that level of deferrals, or if additional financing would be available (Tr. 1411-
6 12).

7 UNSE also contends that, even if sufficient financing were available for such deferrals, the
8 proposed interest on under-collected balances would not be sufficient to cover the Company's actual
9 financing costs because its borrowing rate on the revolving credit facility is based on LIBOR plus 1
10 percent, while Staff recommends maintaining the POA interest rate at the applicable one-year
11 Nominal Treasury Constant Maturities. The Company requests that no cap be placed on the forward
12 component at this time but, if such a cap is imposed, the Commission should set the POA interest rate
13 at LIBOR plus 1, and approve a "circuit breaker" mechanism that would allow a forward component
14 price adjustment if the deferral balance reaches more than 5 percent of the Company's total
15 capitalization.

16 Staff asserts that, according to UNSE Exhibit 43, the Company's estimated total rates (based
17 on projected purchased fuel and purchased power costs from June 2008 through May 2009),
18 including the forward component rates, would increase dramatically in the event of increases in the
19 price of natural gas supplies. For example, according to Staff, UNSE Exhibit 43 shows the forward
20 component of the PPFAC alone would range from 0.48 cents/kWh (\$6.00 MMBtu gas), to 1.73
21 cents/kWh (\$7.50 MMBtu gas), to 2.98 cents/kWh (\$9.00 MMBtu gas). Based on these natural gas
22 price assumptions, the projected rate increases compared to current rates (including the UNSE
23 proposed base rate increase) would be 8.8 percent with \$6.00 MMBtu gas, 21.5 percent with \$7.50
24 MMBtu gas, and 34.2 percent with \$9.00 MMBtu gas. Staff therefore believes a cap is appropriate to
25 mitigate potential rate shock.

26 Based on UNSE's base forecast of power costs (assuming gas at \$7.50 MMBtu), Staff
27 recommended a cap of 1.73 cents per kWh for the forward component, which could not be exceeded
28 without a Commission Order. Staff claims that if the cap were implemented, as it recommends, the

1 total rate increase (including base rates) would be no more than 21.5 percent. Staff argues that,
2 although APS's PSA contains an annual cap of 4 mils, the same type of cap would not be appropriate
3 for UNSE, because UNSE does not own any base load generation and its power costs are therefore
4 subject to a greater degree of volatility. According to Staff, a cap on PPFAC rates based on natural
5 gas price increases would be more appropriate for UNSE.

6 Staff's recommended 1.73 cents per kWh cap, although introduced late in the hearing process,
7 was based on documents provided after Staff's final testimony was filed, and which documents raised
8 very real concerns by Staff regarding the possible magnitude of sudden and dramatic fuel and
9 purchased power increases that could be experienced by customers. We believe Staff's cap
10 recommendation provides an appropriate balance between the need to protect customers from
11 potential rate shock with the Company's need to recover fuel and purchased power costs in a timely
12 manner. The initial PPFAC rate, effective June 1, 2008, shall be set at 1.4746 cents per kWh.

13 Finally, we disagree with the Company's alternative interest rate and circuit breaker
14 proposals. In Decision No. 70011, we rejected a proposal by UNS Gas for approval of an interest rate
15 of LIBOR plus 1 percent on the company's PGA bank balance, based on Staff's explanation of the
16 history of how adjustor mechanism interest rates were established and the interest rates in effect for
17 APS and Southwest Gas (Decision No. 70011, at 77-80). We do not believe UNSE has presented a
18 sufficient basis for departing from the PPFAC interest rate proposed by Staff, which is based on the
19 one-year Nominal Treasury Constant Maturities rate and is comparable to the rate approved for
20 APS's PSA that currently exists. In addition, as we noted in the UNS Gas case, "granting a higher
21 interest rate could provide a disincentive for the Company to reduce bank balances and could cause it
22 to become less focused on taking all possible measures to reduce the cost of gas for its customers"
23 (*Id.* at 80).

24 RUCO's Proposed PPFAC

25 RUCO opposes the PPFAC proposal supported by UNSE and Staff. Ms. Diaz Cortez
26 proposes a PPFAC structure that would automatically adjust on a monthly basis, based on a 12-month
27 rolling average of purchased power and fuel costs. RUCO's proposal would also include a 6 mils per
28 year cap and a 90/10 sharing mechanism (RUCO Ex. 8, at 10-14). Ms. Diaz Cortez contends that a

1 rolling average adjustor would send appropriate price signals to customers as fuel costs increase or
2 decrease, while also smoothing out wide fluctuations in fuel costs. She also stated that RUCO's cap
3 proposal would provide protection for customers from sudden large increases, and that the 90/10
4 sharing mechanism would provide an incentive for the Company to better control its fuel and
5 purchased power costs (RUCO Ex. 10, at 7-8).

6 Staff and the Company oppose the RUCO PPFAC proposal. Staff witness Smith stated that
7 Staff prefers a forward mechanism that adjusts only once a year, and that a rolling average based
8 adjustor could reduce regulatory scrutiny, increase the level of deferrals, and cause customer
9 confusion due to frequent rate changes (Ex. S-56, at 79-80). On the witness stand, Mr. Smith also
10 expressed concern with the 6 mil cap mechanism proposed by RUCO because the cap is too low for
11 UNSE and could result in significant deferrals (Tr. 1392-93).

12 Company witness DeConcini stated that RUCO's proposed sharing mechanism is
13 inappropriate for UNSE because, unlike APS, UNSE has no current baseload generation and is in the
14 process of acquiring new power resources (Ex. A-15, at 14). He added that a sharing mechanism
15 would expose the Company to volatility in the short-term power markets and could lead to a
16 confiscatory rate policy, because short-term resource costs are largely beyond the Company's control
17 (*Id.*).

18 As stated above, we believe Staff's PPFAC recommendations are reasonable and should be
19 adopted. Both the Staff and Company witnesses pointed out potential problems with the adjustor
20 mechanism advocated by RUCO, including the possibility that significant deferrals could be
21 experienced by UNSE under a rolling average structure, the diminished regulatory oversight with
22 such a mechanism, and that it could cause confusion and customer dissatisfaction from frequent rate
23 adjustments. The witnesses also stated the reasons why a sharing mechanism is not appropriate for
24 UNSE, at this time, because of the potential volatility that would likely be experienced by the
25 Company at a time when it is acquiring new sources of power to replace its long-standing full
26 requirements contract.

27 ...

28 ...

1 Purchased Power Allocation

2 UNSE witness Erdworm initially proposed allocating purchased power costs using an
3 "average and peaks" methodology that, as Staff witness Radigan stated, is comprised of an average
4 demand component and a peak demand component (Ex. A-18, at 6-7; Ex. S-62, at 2). UNSE's
5 original proposal would have allocated 100 percent of Accounts 555 and 565 based on average and
6 peaks. However, in his rebuttal testimony, Mr. Erdworm modified the Company's proposal to a 40
7 percent average and peaks and 60 percent energy allocation, based on his claim that the UNSE system
8 has a lower load factor than TEP (which he estimated would be allocated at 50 percent of production
9 costs based on average and peaks and 50 percent of production costs based on energy).

10 Staff witness Radigan testified that purchased power should be allocated with a 100 percent
11 energy component in accordance with the Pinnacle West contract, which has no provision for demand
12 charges or segregation of charges by time of day, month or season (Ex. S-62, at 2). He stated that the
13 Company has provided no credible evidence that the average and peaks method should be used in this
14 case (*Id.*).

15 We agree with Staff that UNSE's proposed imposition of a purely hypothetical allocation
16 methodology in this case should be rejected. As Mr. Radigan pointed out, "[h]owever much Mr.
17 Erdworm tries to reverse engineer this energy charge into demand and energy components, the simple
18 fact remains that the purchased power charge is purely volumetric." (*Id.*). We will therefore adopt
19 Staff's purchased power allocation recommendation.

20 Black Mountain Generating Station

21 According to UNSE witness DeConcini, the Company has a base demand of 200 to 250 MW,
22 with a peak demand of 450 MW (Ex. A-14, at 1). As stated above, UNSE currently obtains all of its
23 power through a full requirements contract with Pinnacle West, which contract expires May 31, 2008.
24 As a result, the Company is pursuing alternative sources to replace the expiring agreement, including
25 the possibility of purchasing a 90 MW peaking facility called the Black Mountain Generating Station
26 ("BMGS") that is planned to be constructed near Kingman, Arizona by an affiliate company,
27 UniSource Energy Development Company ("UED").

28 ...

UNSE

UNSE projects that the BMGS will have a total cost of \$60 to \$65 million and, to date, all costs have been incurred by UED (Tr. 89). The Company seeks to include only up to \$60 million of the plant costs in this case. In order to acquire the BMGS, UNSE proposed a novel ratemaking treatment that would recognize post-test year rate base treatment of the facility before the plant is completed or owned by UNSE. UNSE claims that acquisition of the BMGS would provide operational and financial benefits for the Company, and is a unique opportunity that would allow UNSE to diversify its power supply portfolio. The Company claims that if rate base treatment of the plant is denied in this case, the opportunity to acquire the BMGS would be lost or delayed.

According to Mr. DeConcini, UED has agreed to sell the plant to UNSE at cost, and UNSE has agreed to limit rate recovery to the amount of UED's actual cost of construction, as well as submitting to a subsequent prudence evaluation of the plant's costs (Ex. A-14, at 9; Ex. A-15, at 4). UNSE claims that the \$60 million rate base addition would increase the Company's revenue requirement in this case by approximately \$10 million.

Operational benefits of the acquisition cited by the Company include: having operational flexibility to meet required reserves and ancillary services, and economic dispatch capabilities; UNSE would have full control over maintenance and operation of the plant; generation would be owned by UNSE to meet reserve needs; and generation would be available in a location where transmission costs can be minimized, and would provide necessary must-run energy and allow for connection to dual systems for redundancy (Ex. A-15, at 6-7).

The primary advantage cited by UNSE for inclusion of the BMGS in rate base is the discounted cost of the plant due to the affiliate relationship with UED. UNSE claims that UED acquired two 2003 vintage LM6000 turbines in 2006 at a discount of approximately 25 percent compared to current prices (Ex. A-14, at 11-14). UNSE also claims that acquisition of the plant would provide long-term financial benefits to customers compared to purchasing wholesale power. Company witness Larson estimated that the cost of owning the BMGS would be approximately \$12 million less than purchasing wholesale power, on a net present value basis over 30 years (Ex. A-10, at 2). He also contends that having an additional \$10 million in non-fuel revenues would add

1 approximately \$6 million to the Company's cash flows, and \$3 million to net income, and provide
2 UNSE a reasonable opportunity to earn a return on the BMGS (Ex. A-8, at 3, 10).

3 Mr. Larson stated that, given the looming maturity of all \$60 million of UNSE's long-term
4 debt in August 2008, the only realistic chance for UNSE to acquire the BMGS is to be allowed to
5 implement a post-test year adjustment to rate base, and a corresponding rate reclassification when the
6 plant becomes operational (Ex. A-9, at 6). The Company also asserts that the BMGS must be
7 accorded rate base treatment in this case, because the deferred accounting treatment recommended by
8 Staff would not provide the Company with sufficient cash flows to support the estimated cost of
9 acquiring the plant (*Id.*). Mr. Larson claims that adoption of Staff's deferral proposal would leave
10 UNSE no choice but to file another rate case as soon as this proceeding is concluded, because the
11 Company would likely not have the ability to attract the capital needed to finance the plant
12 acquisition without certainty of rate recovery through rates in this case (*Id.* at 7).

13 Staff

14 Staff opposes inclusion of \$60 million in rate base for the BMGS. Staff witness Ralph Smith
15 testified that such rate base inclusion would violate the traditional test year matching concept, and
16 would not be consistent with sound ratemaking principles (Ex. S-56, at 89-92; Ex. S-58, at 64-65).
17 Mr. Smith indicated that UNSE should consider filing an application to seek deferred accounting
18 treatment for the plant as a means of recovering plant costs in its next rate case. He stated that such a
19 process would more closely synchronize the timing of plant operations with rate recovery (Ex. S-56,
20 at 90-91).

21 Staff cites a host of concerns with approving rate base treatment of the BMGS in this case,
22 including the fact that the plant is not expected to be operational until May or June of 2008, dates that
23 are well beyond the test year, the hearing, and even the expected effective date of this Decision. Staff
24 also points out that the plant is being constructed in its entirety by UED and, therefore, UNSE has not
25 been subjected to cash flow issues associated with the plant's construction. Staff also claims that
26 there is ongoing uncertainty regarding: the eventual total cost of the plant; whether ultimate
27 ownership will rest with UNSE or UED; the plant's operational and maintenance costs; whether the
28 plant's costs are prudent; and whether it would be more economical for the Company to purchase the

1 plant, or to purchase power on the open market. Staff argues that, given these uncertainties, the
2 BMGS should not be included in the Company's rate base at this time.

3 RUCO

4 RUCO similarly opposes inclusion in rate base for the BMGS. RUCO argues that neither the
5 capital costs nor the operating costs of the plant are known, at this time, and it is therefore premature
6 to grant approval before the plant is even finished. Although the Company has agreed to a post-rate
7 base inclusion prudence review, RUCO is concerned that customers would be required to begin
8 paying for a plant before it is completed and prior to analysis in a rate case regarding prudence of the
9 plant costs. RUCO claims that such action by the Commission would set an inappropriate precedent.

10 RUCO witness Diaz Cortez also stated that adoption of UNSE's proposal would violate the
11 ratemaking matching principle because customer counts at the time of the plant's completion would
12 be different than the customer counts used in this case for setting rates. She indicated that there is no
13 way for the Commission to know the incremental costs, or cost savings, between the test year and the
14 post-test year in-service date for the BMGS, thereby resulting in piecemeal ratemaking (RUCO Ex.
15 10, at 5). Ms. Diaz Cortez also testified that approval of the Company's request would violate the
16 ratemaking principle that only "used and useful" plant should be accorded rate recognition. Finally,
17 she questioned the lack of opportunity for greater scrutiny of a transaction between affiliated entities
18 under UNSE's proposal (RUCO Ex. 8, at 7).

19 Conclusion

20 For the reasons they cite, we agree with Staff and RUCO that the BMGS should not be
21 included in rate base at this time. However, the temporal coincidence of two circumstances specific
22 to this case, expiration of UNSE's contract with Pinnacle West two weeks from now and imminent
23 commercial operation of the plant²⁰, is a compelling basis on which to encourage UNSE's acquisition
24 of the BMGS. To provide such encouragement, we will authorize UNSE to implement an accounting
25 order to record any and all of the Company's financial activities associated with the BMGS, as if the
26

27 ²⁰ UNSE's May 5, 2008 Exceptions at page 4, lines 6-9: "As of May 1, 2008, both gas combustion turbines of the BMGS
28 have been in operation and have synchronized with the grid, *producing power*. Performance testing is planned for the
next two weeks and *commercial operation is scheduled for mid-May 2008*." (emphases added)

1 BMGS were in rate base as of June 1, 2008. Unless otherwise ordered by the Commission, this
2 accounting order would remain in effect until the effective conclusion of UNSE's next rate case.

3 Financing Approval for the BMGS

4 Concurrent with its request for rate base treatment of the BMGS, UNSE seeks approval of a
5 financing request that would enable the Company to issue up to \$40 million of new debt securities,
6 and receive up to \$40 million of additional equity contributions from UniSource Energy. Mr. Larson
7 indicated that the Company would also require some flexibility regarding the mix of debt and equity
8 in order to best take advantage of market conditions (Ex. A-8, at 15-17). Mr. Larson stated that the
9 requested debt issuance would be in addition to that approved in Decision No. 69395 (March 22,
10 2007), and that long-term debt would be secured by the BMGS assets or other UNSE assets. Under
11 the Company's proposal, short-term debt issuances (up to 5 years maturity) could be secured or
12 unsecured, with either fixed or variable rates (*Id.*).

13 Regarding the equity infusion component of the request, UNSE seeks authority to receive
14 from UniSource Energy up to \$40 million in additional equity, over and above any contributions that
15 would otherwise be allowed under Commission rules or Orders. Mr. Larson claims that this equity
16 infusion would enable UNSE to purchase the BMGS and provide the Company an opportunity to
17 maintain a balanced capital structure (*Id.*). The Company contends that, absent approval of its
18 combined debt and equity financing proposal, it would not be able to finance the purchase of the
19 BMGS.

20 Staff recommended approval of the requested financing authority subject to certain
21 conditions, which were subsequently agreed to by the Company. Staff witness Alexander Igwe
22 testified that the financing request should be approved subject to the following conditions:

- 23
- 24 1) The \$40 million of new debt financing and \$40 million in new equity
should be used for the sole purpose of acquiring the BMGS;
 - 25 2) The \$40 million of new debt financing may be comprised of long-term
26 debt and short-term to intermediate-term debt;
 - 27
 - 28

- 3) UNSE should be permitted to refinance any of the short-term or intermediate-term debt approved by this docket, to long-term debt, without further Commission approval;
- 4) UNSE should be authorized to issue guarantees and to grant liens on some or all of its assets, including the BMGS, and any other assets acquired subsequent to acquisition of the BMGS, to secure its obligations under the proposed debt issuance and to secure other obligations at the time such liens are granted;
- 5) UNSE should be authorized to engage in any transactions to execute, or cause to be executed, any documents necessary to effectuate the requested authorizations;
- 6) UNSE should be required to file a report with Docket Control, within 60 days from the close of each transaction, demonstrating that it had a debt service coverage ("DSC") ratio and times interest earned ratio ("TIER") equal to or greater than 1.0 at the time of the new debt issuances; and
- 7) UNSE should be required to file a report with Docket Control, within 60 days of the close of each financing package, describing the transaction and demonstrating that the terms are consistent with those generally available to comparable entities (Ex. S-54, at 5-7).

Mr. Igwe indicated that the grant of the Company's financing proposal would not have a material impact on Staff witness Parcell's recommended capital structure, but the exact impact of the financing secured by UNSE on its capital structure could not be determined, at this time, given the Company's need for flexibility regarding the mix of debt and equity it ultimately achieves to finance the BMGS acquisition.

With respect to the requested financing, we agree with Staff that UNSE's requests for approval of up to \$40 million of new debt financing, and up to \$40 million of equity infusion from UniSource Energy, are measures that should be approved subject to the parameters outlined by Staff. The Company's proposal for securing financing for the purpose of acquiring the BMGS is reasonable, and is therefore approved in accordance with Staff's recommendations, as outlined above. However, approval of the financing set forth herein does not constitute or imply approval or disapproval by the Commission of any particular expenditure of the proceeds derived thereby for purposes of establishing just and reasonable rates.

* * * * *

1 Having considered the entire record herein and being fully advised in the premises, the
2 Commission finds, concludes, and orders that:

3 **FINDINGS OF FACT**

4 1. On December 15, 2006, UNSE filed an application with the Commission in the above-
5 captioned docket for an increase in its rates throughout its service area in the State of Arizona.

6 2. On January 12, 2007, Staff filed a Letter of Sufficiency indicating that the Company's
7 application, as supplemented by additional information filed on January 11, 2007, met the sufficiency
8 requirements outlined in A.A.C. R14-2-103, and classifying the Company as a Class A utility.

9 3. On February 1, 2007, a Procedural Order was issued scheduling a hearing for
10 September 10, 2007; directing UNSE to publish notice of the application; and setting various other
11 procedural deadlines.

12 4. Intervention was granted to RUCO, APS, and Marshall Magruder.

13 5. With its application in the Rate Case, UNSE filed its required schedules in support of
14 the application, and the direct testimony of various witnesses.

15 6. On June 28, 2007, Staff, RUCO, and Mr. Magruder filed direct testimony in
16 accordance with the previously established procedural schedule. Staff, RUCO and Mr. Magruder
17 filed additional direct testimony on July 12, 2007.

18 7. On August 14, 2007, UNSE filed the rebuttal testimony of various witnesses in
19 response to Staff and intervenor testimony.

20 8. Surrebuttal testimony was filed by Staff, RUCO, and Mr. Magruder on August 24,
21 2007.

22 9. On August 31, 2007, UNSE filed the rejoinder testimony of several witnesses in
23 response to the surrebuttal testimony of Staff and intervenor witnesses.

24 10. The evidentiary hearing commenced as scheduled on September 10, 2007, and
25 additional hearing days were held on September 11, 12, 13, 14, 20 and 21, 2007, and on October 2,
26 2007.

27 11. Final Schedules were filed on October 11, 2007, October 16, 2007 and October 17,
28 2007, respectively, by UNSE, Staff and RUCO.

12. Initial Post-Hearing Briefs were filed on November 5, 2007, by UNSE, Staff, and RUCO, and on November 6, 2007, by Mr. Magruder.

13. Reply Briefs were filed on November 14, 2007, by RUCO, on November 16, 2007, by Mr. Magruder, and on November 19, 2007, by UNSE and Staff.

14. On December 27, 2007, Mr. Magruder filed late-filed exhibits in response to UNSE's reply brief.

15. On January 9, 2008, UNSE filed a response to Mr. Magruder's late-filed exhibits.

16. On January 15, 2008, Mr. Magruder filed a reply to UNSE's response.

17. According to the Company's application, as modified, in the test year ended June 30, 2006, UNSE had adjusted operating income of \$8,770,016 on an adjusted OCRB of \$141,036,562, for a 6.22 percent rate of return.

18. UNSE requests a revenue increase of \$8,468,638; Staff recommends a revenue increase of \$3,687,885; and RUCO recommends a revenue increase of \$1,282,144.

19. For purposes of this proceeding, we determine that UNSE has an OCRB of \$130,740,050 and a FVRB of \$167,551,067.

20. A rate of return on FVRB of 7.03 percent is reasonable and appropriate.

21. The Company's attempt to interject the issue of the *Chaparral City* decision through its rebuttal testimony, and its attempt to apply the weighted average cost of capital to FVRB is not reasonable and is not supported by the testimony and evidence in the record.

22. UNSE is entitled to a gross revenue increase of \$4,018,678.

23. The class responsibility for the revenue requirement should be allocated using the methodology of Staff's rate design expert witness.

24. For residential customers, the basic monthly customer charge should be increased from \$6.50 to \$7.50, with a volumetric "base rate" charge of \$0.089248 per kWh for the first 400 kWh, and \$0.09926 per kWh for usage over 400 kWh, for customers in both Mohave and Santa Cruz Counties. The volumetric "base rates" reflect the consolidation of rates for Mohave and Santa Cruz customers and the inverted block rate structure (see discussion below). However, these volumetric rates do not include the additional PPFAC charge, which is being set initially at \$0.014746 per kWh

1 for all usage.

2 25. The rates for Mohave and Santa Cruz Counties should be consolidated into a single
3 rate structure.

4 26. For CARES customers, the current discount applicable to the entire bill should be
5 retained, based on total monthly usage (*i.e.*, usage of 300, 600 or 1,000 kWh for CARES and 600,
6 1,200 or 2,000 kWh for CARES-Medical would trigger progressively smaller discounts).

7 27. The rates for other customer classes should be set based on Staff's rate design
8 recommendation, with the customer charges for each class established at the level recommended by
9 Staff and with volumetric charges based on the revenue requirement determined herein. The only
10 exception shall be that residential and small general service customers shall use UNSE's inverted
11 block rate design based on the revenue requirement determined herein.

12 28. The billing determinants proposed by the Company should be employed for setting
13 rates in this proceeding.

14 29. Staff's recommendation to set the DSM adjustor surcharge at an initial level of
15 \$0.000583, is reasonable. In addition, it is reasonable to require UNSE to file semi-annual reports for
16 the DSM programs, to shift the adjustor filing date to April 1 (with an Adjustor date of June 1), and
17 that the appropriate forum for a full review of the specific DSM programs is in the separate docket in
18 which there is an application currently pending.

19 30. DSM programs should be funded at the level recommended by Staff: 100 percent of
20 expanded LIW program costs, and 25 percent of the other DSM program costs, funded through the
21 adjustor mechanism.

22 31. With respect to the Company's PPFAC mechanism, we adopt Staff's
23 recommendations, including limitation of expenses to those recorded in FERC Accounts 501, 547,
24 555 and 565, and implementation of an annual PPFAC cap of 1.73 cents per kWh on the forward
25 component of the PPFAC.

26 32. The interest rate for the Company's PPFAC bank balance should be retained, based on
27 one-year Nominal Treasury Constant Maturities, in accordance with Staff's recommendation.

28 33. Staff's purchased power allocation recommendation is reasonable and should be

1 adopted.

2 34. Staff's recommendation to approve a REST adjustor mechanism, in accordance with
3 the REST rules, is reasonable and should be approved. The new REST adjustor will replace the EPS
4 surcharge and any remaining EPS funds would be applied to the REST program.

5 35. With respect to the use of payday loan stores for acceptance of customer payments,
6 Company should file, within 60 days of the effective date of this Decision, an updated report
7 regarding implementation of the PayScan™ program.

8 36. The Company's line extension policies should be amended to eliminate the free
9 footage allowance currently in effect. However, the Company's proposed \$250 Service Connection
10 Charge should not be adopted.

11 37. UNSE's proposed billing change, to reduce from 15 days to 10 days, the date for
12 customers to pay bills before the bills are considered past due, is reasonable, subject to the condition
13 that payments would not be considered delinquent, and therefore subject to late charges, until at least
14 25 days after issuance of the bill, and the service termination timeline would remain unchanged.
15 However, in accordance with the Decision No. 70011, UNSE should not implement the approved
16 billing change for at least six months following the effective date of this Decision.

17 38. The Company's proposal to include the Black Mountain Generating Station in base
18 rates should not be approved because, among other things, the plant was not operational during the
19 test year, and is therefore not used and useful for ratemaking purposes; UNSE does not yet have
20 ownership of the plant; the plant costs have not been determined to be prudent by the Commission;
21 and the final cost of the plant is unknown since it has not been completed.

22 39. UNSE's financing request, for approval of up to \$40 million of new debt financing,
23 and up to \$40 million of equity infusion from UniSource Energy, are measures that should be
24 approved subject to the parameters outlined by Staff. The Company's proposal for securing
25 financing for the purpose of acquiring the BMGS is reasonable, and should therefore be approved in
26 accordance with Staff's recommendations.

27 40. UNSE proposed to revise the Rules and Regulations provisions in its tariffs,
28 specifically Section 12, which addresses Termination of Service, to add "EFTs or other financial

1 instruments" to a provision that allows the Company to disconnect electric service without notice
2 under the condition when NSF checks have not been made good. We believe that the customer
3 should be given notice so as to have an opportunity to make good on the check, EFT, or other
4 financial instrument. Therefore, the condition of NSF checks, EFTs, or other financial instruments
5 that have not been made good should be included with the conditions under which service can be
6 terminated with notice and should be deleted from the conditions under which service can be
7 terminated without notice.

8 41. In view of the expiration of UNSE's power supply contract with Pinnacle West on
9 May 31, 2008, and imminent commercial operation of the BMGS, it is in the public interest to
10 authorize UNSE to implement an accounting order to record UNSE's financial activities associated
11 with the BMGS, as if the BMGS were in rate base as of June 1, 2008. UNSE may use the accounting
12 order to seek recovery of BMGS-related costs in the Company's next rate case.

13 CONCLUSIONS OF LAW

14 1. UNS Electric is a public service corporation within the meaning of Article XV of the
15 Arizona Constitution and A.R.S. §§40-250, 40-251, and 40-367.

16 2. The Commission has jurisdiction over UNSE and the subject matter of the above-
17 captioned application.

18 3. The fair value of UNSE's rate base is \$167,551,067, and applying a 7.03 percent rate
19 of return on this fair value rate base produces rates and charges that are just and reasonable.

20 4. The rates, charges, approvals, and conditions of service established herein are just and
21 reasonable and in the public interest.

22 5. The deferral authorization granted herein does not constitute a finding or
23 determination that the deferred costs are reasonable, appropriate, or prudent.

24 6. It is in the public interest to authorize UNSE to record UNSE's financial activities
25 associated with the BMGS, as if the BMGS were in rate base as of June 1, 2008, and UNSE may use
26 the accounting order to seek recovery of BMGS-related costs in the Company's next rate case.

27 7. With the conditions imposed herein, the financing approved herein is for lawful
28 purposes within UNSE's corporate powers, is compatible with the public interest, with sound financial

1 practices, and with the proper performance by UNSE of service as a public service corporation, and
2 will not impair UNSE's ability to perform that service.

3 8. The financing approved herein is for the purposes stated in the application and is
4 reasonably necessary for those purposes, and is not reasonably chargeable to operating expenses or
5 income.

6 9. It is reasonable and in the public interest to authorize UNSE to issue debt and receive
7 equity subject to the conditions recommended by Staff.

8 **ORDER**

9 IT IS THEREFORE ORDERED that UNS Electric, Inc., is hereby authorized and directed to
10 file with the Commission, on or before May 31, 2008, revised schedules of rates and charges
11 consistent with the discussion herein and a proof of revenues showing that, based on the adjusted test
12 year level of sales, the revised rates will produce no more than the authorized increase in gross
13 revenues.

14 IT IS FURTHER ORDERED that the revised schedules of rates and charges shall be effective
15 for all service rendered on and after June 1, 2008.

16 IT IS FURTHER ORDERED that UNS Electric, Inc., shall notify its customers of the revised
17 schedules of rates and charges authorized herein by means of an insert, in a form acceptable to Staff,
18 included in its next regularly scheduled billing.

19 IT IS FURTHER ORDERED that UNS Electric, Inc. shall file as a compliance item, within
20 20 days of the effective date of this Decision, a voluntary time of use tariff, for Commission
21 approval.

22 IT IS FURTHER ORDERED that UNS Electric, Inc. may implement an accounting order to
23 record UNSE's financial activities associated with the BMGS, as if the BMGS were in rate base as of
24 June 1, 2008.

25 IT IS FURTHER ORDERED that UNS Electric, Inc. may use the accounting order authorized
26 herein to seek recovery of BMGS-related costs in the Company's next rate case.

27 IT IS FURTHER ORDERED that the deferral authorization granted to UNS Electric, Inc.,
28 herein does not constitute a finding or determination that the deferred costs are reasonable,

1 appropriate, or prudent; and this Decision shall not be construed as providing any relief through rates
2 with respect to the ultimate recovery of the above-authorized deferrals.

3 IT IS FURTHER ORDERED that, if UNS Electric, Inc., intends to seek future recovery
4 through rates of the deferred costs authorized herein, the Company shall prepare and retain
5 accounting records sufficient to permit detailed review, in a rate proceeding, of all such deferred
6 costs.

7 IT IS FURTHER ORDERED that UNS Electric, Inc., shall develop a customer education
8 program for its new inverted block rates and shall submit such a program to Docket Control by June
9 30, 2008, for Commission approval.

10 IT IS FURTHER ORDERED that UNS Electric, Inc., is hereby authorized to incur up to \$40
11 million of new debt financing, in either long-term and/or short to intermediate-term debt, for the
12 purpose of acquiring the Black Mountain Generating Station, and is authorized to refinance any
13 short-term or intermediate-term debt into long-term debt, without further Order of the Commission,
14 as a means of taking advantage of prevailing market conditions.

15 IT IS FURTHER ORDERED that UNS Electric, Inc., is authorized to receive up to \$40
16 million of equity from UniSource Energy for the purpose of acquiring the Black Mountain
17 Generating Station.

18 IT IS FURTHER ORDERED that UNS Electric, Inc., is authorized to issue guarantees and
19 grant liens on some or all of its assets, including the Black Mountain Generating Station, and any
20 other assets acquired subsequent to the acquisition of the Black Mountain Generating Station, to
21 secure its obligations under the proposed debt issuance and to secure other obligations at the time
22 such liens are granted.

23 IT IS FURTHER ORDERED that UNS Electric, Inc., is authorized to engage in any
24 transactions to execute, or cause to be executed, any documents necessary to effectuate the requested
25 authorizations.

26 IT IS FURTHER ORDERED that UNS Electric, Inc., shall file a report with Docket Control,
27 within 60 days from the close of each transaction, demonstrating that it had a debt service coverage
28 ratio and times interest earned ratio equal to or greater than 1.0 at the time of the new debt issuances.

1 IT IS FURTHER ORDERED that UNS Electric, Inc., shall file a report with Docket Control,
2 within 60 days of the close of each financing package, describing the transaction and demonstrating
3 that the terms are consistent with those generally available to comparable entities.

4 IT IS FURTHER ORDERED that UNS Electric, Inc., shall use the financing approved herein
5 for the purposes set forth in the application.

6 IT IS FURTHER ORDERED that UNS Electric, Inc., shall file, as a compliance item with
7 Docket Control, within 90 days of the funding of any new debt under this authorization, copies of the
8 executed loan documents.

9 IT IS FURTHER ORDERED that approval of the financing set forth herein does not
10 constitute or imply approval or disapproval by the Commission of any particular expenditure of the
11 proceeds derived thereby for purposes of establishing just and reasonable rates.

12 IT IS FURTHER ORDERED that UNS Electric, Inc., shall set the DSM adjustor surcharge at
13 an initial level of \$0.000583 per kWh, adjusted annually on June 1 of each year, beginning June 1,
14 2009, and shall make its DSM adjustor filing by April 1 of each year, beginning April 1, 2009.

15 IT IS FURTHER ORDERED that UNS Electric, Inc., shall file semi-annual reports for its
16 DSM programs in accordance with Staff's recommendations.

17 IT IS FURTHER ORDERED that the depreciation rates proposed by UNS Electric, Inc., with
18 Staff's recommended treatment, are approved.

19 IT IS FURTHER ORDERED that UNS Electric, Inc., shall file a detailed response to Mr.
20 Magruder's allegations regarding the poles and underground cables under the 1999 Nogales/Citizens
21 Settlement Agreement, within 60 days of the effective date of this Decision. Replies to the
22 Company's response shall be filed by Mr. Magruder, Staff, and RUCO within 30 days thereafter.

23 IT IS FURTHER ORDERED that UNS Electric, Inc., shall, within 60 days of the effective
24 date of this Decision, in a form acceptable to Staff, clarify the language on its website to more clearly
25 describe the CARES discounts that are available, especially to delineate that the discount applicable
26 to the entire bill is based on total monthly usage (*i.e.*, usage of 300, 600 or 1,000 kWh for CARES
27 and 600, 1,200 or 2,000 kWh for CARES-Medical would trigger progressively smaller discounts). In
28 addition, UNSE shall separately report Cares-Medical participation in its CARES report, in

1 accordance with Staff's recommendation.

2 IT IS FURTHER ORDERED that UNS Electric, Inc., shall, within 60 days of the effective
3 date of this Decision, place a section on customer bill payment stubs that allows customers to check a
4 box to indicate they would like to make a contribution to the Warm Spirits program.

5 IT IS FURTHER ORDERED that UNS Electric, Inc., shall file, within 60 days of the
6 effective date of this Decision, an updated report regarding implementation of the PayScan™
7 program.

8 IT IS FURTHER ORDERED that UNS Electric, Inc., shall initiate a meeting with Mr.
9 Magruder, within 30 days of the effective date of this Decision, and file within 90 days of the
10 effective date of this Decision, a statement regarding suggested resolution of the concerns raised by
11 Mr. Magruder with respect to the student loans and scholarships issue.

12 IT IS FURTHER ORDERED that UNS Electric, Inc., shall file, within 30 days of the
13 effective date of this Decision, a revised line extension tariff consistent with the discussion
14 hereinabove, including a transition plan, for Commission approval.

15 IT IS FURTHER ORDERED that UNS Electric, Inc., shall not implement the approved
16 billing changes regarding payment due dates for 6 months following the effective date of this
17 Decision.

18 IT IS FURTHER ORDERED that UNS Electric, Inc., shall file with Docket Control, within
19 30 days of the effective date of this Decision, a revised bill estimation tariff, in accordance with
20 Staff's recommendations for Commission approval.

21 IT IS FURTHER ORDERED that Staff's recommendation to approve a REST adjustor
22 mechanism, in accordance with the REST rules, shall be approved. The new REST adjustor will
23 replace the EPS surcharge and any remaining EPS funds would be applied to the REST program.

24 IT IS FURTHER ORDERED that Staff's recommended revisions to the Company's PPFAC
25 mechanism is approved, including limitation of expenses to those recorded in FERC Accounts 501,
26 547, 555 and 565, and implementation of an annual PPFAC cap of 1.73 cents per kWh on the forward
27 component of the PPFAC.

28 IT IS FURTHER ORDERED that UNS Electric, Inc. shall file, within 30 days of the effective

1 date of this Decision, a revised POA in accordance with the discussion hereinabove.

2 IT IS FURTHER ORDERED that UNS Electric, Inc. shall set the initial PPFAC rate,
3 effective June 1, 2008, at 1.4746 cents per kWh.

4 IT IS FURTHER ORDERED that UNS Electric, Inc., shall consolidate the rates for customers
5 in Mohave and Santa Cruz Counties into a single rate structure.

6 IT IS FURTHER ORDERED that UNS Electric, Inc., shall revise its tariffs in accordance
7 with Finding of Fact No. 40 so that NSF checks, EFTs, or other financial instruments that have not
8 been made good are included as conditions under which service can be terminated with notice.

9 IT IS FURTHER ORDERED that UNS Electric, Inc., shall file to file, within 90 days of the
10 effective date of this Decision, a statement regarding suggested changes to its procedures that may
11 address the concerns raised by Mr. Magruder customers on life support equipment.

12 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

13 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

14
15 *Samuel S. Gleason*
16 CHAIRMAN

William A. Munck
COMMISSIONER

17 *Jeffrey H. Hatch-Noller*
18 COMMISSIONER

Brian C. McNeil
COMMISSIONER

Gary J. Dean
COMMISSIONER

19
20 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
21 Director of the Arizona Corporation Commission, have
22 hereunto set my hand and caused the official seal of the
23 Commission to be affixed at the Capitol, in the City of Phoenix,
24 this 27th day of May, 2008.

25 *Brian C. McNeil*
26 BRIAN C. McNEIL
27 EXECUTIVE DIRECTOR

28 DISSENT _____

DISSENT _____

1 SERVICE LIST FOR: UNS ELECTRIC, INC.

2 DOCKET NO.: E-04204A-06-0783

3

4 Michael W. Patten
5 ROSHKA, DeWULF & PATTEN
6 One Arizona Center
400 East Van Buren Street, Suite 800
Phoenix, AZ 85004

Ernest G. Johnson, Director
Utilities Division
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, AZ 85007

7 Michelle Livengood
8 UNISOURCE ENERGY SERVICES
9 One South Church Street, Suite 200
Tucson, AZ 85702

10 Thomas L. Mumaw
Deborah A. Scott
11 PINNACLE WEST CAPITAL CORP.
12 P.O. Box 53999, Mail Station 8695
Phoenix, AZ 85072-3999

13 Barbara A. Klemstine
14 ARIZONA PUBLIC SERVICE COMPANY
15 P.O. Box 53999, Mail Station 9708
Phoenix, AZ 85072-3999

16 Robert J. Metli
17 SNELL & WILMER, L.L.P.
18 One Arizona Center
400 East Van Buren Street
Phoenix, AZ 85004-2202

19
20 Marshall Magruder
21 PO BOX 1267
Tubac, AZ 85646-1267

22 Scott W. Wakefield, Chief Counsel
23 RUCO
1110 W. Washington, Ste. 200
24 Phoenix, AZ 85007

25 Janice Alward, Chief Counsel
Legal Division
26 ARIZONA CORPORATION COMMISSION
1200 West Washington Street
27 Phoenix, AZ 85007
28